Nottinghamshire County Council

Report to Pensions Sub-Committee

6 February 2014

Agenda Item:6

REPORT OF SERVICE DIRECTOR – FINANCE & PROCUREMENT

LAPFF CONFERENCE 2013

Purpose of the Report

1. To report on the LAPFF Conference 2013 held in Bournemouth.

Information and Advice

2. The LAPFF Conference 2013 was held on 4th to 6th December 2013 at the Highcliff Marriott Hotel in Bournemouth. In accordance with prior approval and as part of the Fund's commitment to ensuring those charged with decision-making and financial management have effective knowledge and skills; the conference was attended by Councillor Darrell Pulk and Mr Nigel Stevenson (Group Manager – Financial Strategy and Compliance). The theme of this year's conference was Licence to Operate: Holding Companies to Account.

3. ***David Pitt-Watson – Executive Fellow, London Business School***
The conference began with David Pitt-Watson reflecting back on the history of improving corporate governance arrangements in British companies, starting with the Cadbury Committee report in the early 1990's. This report set out recommendations on the arrangement of company boards and accounting systems to mitigate corporate governance risks and failures. The Committee's aims were to investigate the British corporate governance system and to suggest improvements to restore investor confidence in the system.

   The report's recommendations have been used to varying degrees to establish other codes such as those of the European Union and in the United States and David reflected upon his involvement in helping shape some of these codes.

   David set out the objectives of the LAPFF Conference, which would explore today's issues with corporate governance and the engagement opportunities that investors should utilise.

4. ***Does activism enhance company value for investors?***
This session began with David Trenchard, Vice Chairman of Knight Vinke explaining what activism was about. This investment approach involves, to varying degrees, taking opportunities in undervalued companies or companies with governance issues and by investment taking a more active role in improving governance and financial performance. Knight Vinke invests in large companies (including multi-nationals) with only relatively small holdings, and their edge is by way of very deep forensic financial analysis. David talked

about long term engagement, over holding periods longer than 3 years, directly with the boards of these companies all aimed to improve financial performance.

This was followed by Alex Pauisco, CEO and Founding Partner, DBay Advisors, who explained his company's approach to activism mainly in US companies. The strategy in the USA varies due to the different legislation affecting investors from that in the UK and Europe. The strategy therefore tends to appear more aggressive. However, their approach is similar to Knight Vinke in undertaking very detailed forensic financial analysis, again with relatively small shareholding in companies. The holding is typically only 5% but an amount that is sufficient to obtain rights in adding items to company AGMs. Again this enables direct engagement with company boards with the aim to improve financial performance, although the specific example provided did appear to be more related to financial engineering by a review of the value of the assets held on the balance sheet.

Bryan Schneider, Senior Vice President, Entrust Capital Inc. followed with insights again mainly drawn from experiences of activism in the USA from a very large activist fund perspective. It is typical that activist managers build up a network of success both in being able to introduce new managers to companies to improve performance and in them being able to spot effective strategies to improve companies. This experience also enables them to recognise other investors that would follow these activist managers and invest in the new opportunity to add value to the company.

Directors of companies sometimes do not understand the value in the company and the traditional investor doesn't have the resources to do the deep financial analysis that is required. Likewise, the activist manager may miss opportunities because they spend so much time analysing data but all three speakers indicated that they get it right more times than wrong.

It was stressed by all three speakers that this wasn't short-term investing; however, the longest example provided by any of the speakers was a 5 year investment. And again, due to the very nature of the financial analysis required the activist managers would typically only hold stock in 10 companies and only ever be active in 6 of these at any one time.

5. ***National LGPS Procurement Framework. 'How to save your fund time and money'***
Nicola Mark, Head of Norfolk Pension Fund led a small session on the progress being made on the collaborative procurement framework, which is open to all LGPS to use. A number of services, including actuary and advisory services were already on the framework and although there is a charge to use the framework of £7,000 - £8,000 the more LGPS using the framework would increase the rebate available to the users. Using the framework would reduce the time and cost in tendering for a number of services.

6. ***Audit and Accounting (IFRS)***
Tim Bush from PIRC Ltd and Ian Richards from Threadneedle Investments presented an update since the publication by LAPFF entitled 'UK and Irish Banks Capital Losses - Post Mortem' and Ian's publication entitled 'Bringing Audit Back from the Brink'. Both papers looked at the near total collapse of the UK and Irish capital adequacy regimes where it became clear that those charged with setting accounting standards had made errors in those standards particularly related to banks. In addition, the auditors were heavily criticised for failing to spot the bad practices that contributed to the onset of the financial crisis in

2008, while the Financial Reporting Council's (FRC) ongoing audit inspections have already identified various failings in how financial institutions are audited.

Both Tim and Ian were concerned that no changes are proposed to the accounting standards and they believe losses of £50bn still exist in the banking system. In May 2013 LAPFF, together with the Investor Coalition, sought advice from a leading QC (George Bompas). His opinion indicated that company law should prevail over accounting standards which is not showing a 'true and fair view' of banks' balance sheets and that some specific IFRS outcomes are problematic.

Recently LAPFF has published a follow up report as a result of criticism from the Financial Reporting Council (FRC). This set out the arguments put by LAPFF as to the systematic failure of the accounting standards regime and the underlying issue of the backward looking loan loss provisioning model that made sub-standard lending appear highly profitable. Both speakers indicated that it was disappointing that five years on from the banking crisis very little has been done to address the inadequacies in the accounting standards.

Since the LAPFF conference the Financial Reporting Council (FRC) has announced (13 December 2013) that it will conduct a formal review of banks audits in the second quarter of 2014 as soon as this year's annual reports have been completed to find out why progress in improving their quality has been so slow. "Concerns about the quality of auditing of banks and building societies persist," said Baroness Hogg, chairman of the FRC. "The issues and concerns that have been raised mean that a specific review of audit in this sector is warranted".

7. ***Licence to Operate: Community responsibilities of companies***
Josh Hardie, Corporate Responsibility Director, Tesco PLC spoke about Tesco's approach to addressing community responsibility issues, such as helping to reduce obesity, reducing food waste, creating opportunities for young people through apprenticeships and charitable activities such as helping to provide food for people in poverty. Josh indicated that some of these initiatives were delegated to local stores discretion and that contributing to these initiatives was maintaining customer loyalty, which added to the company bottom-line.

8. ***Holding the rating agencies accountable***
The session was led by Dan Drosman, a partner in Robbins Geller Rudman & Dowd, who led a group of attorneys in the USA prosecuting fraud claims against the credit agencies, where he was distinguished as one of the few plaintiff's counsel to defeat the rating agencies' traditional First Amendment defence and their motions summary judgment based on the mischaracterisation of credit ratings as mere opinions not actionable in fraud. Dan's ground-breaking prosecution of the ratings agencies was the subject of multiple media articles in national and international publications.

Dan's speech ran through the history of rating financial products. Prior to 2007 the 2 times where triple 'A' ratings had failed were during the Spanish Civil War and WW2. By 2007 a number of investor failures appeared. Dan outlined the particular case in 2008 when the hedge fund Chyene Capital Management Ltd. took legal action against Standard & Poor's and Moody's Investor Service Inc. who had given unwarranted investment-grade (AAA) ratings in 2006 to $23bn worth of notes backed by subprime mortgages, the same seal of approval US Treasury bonds get.

Following the disclosure of a vast quantity of internal company emails and correspondence, early in 2013 both rating agencies settled the lawsuits with less than a week before the scheduled start of the first trial.

Dan indicated that it became clear that the rating agencies were driven by the need to hand gold-plated triple A credit ratings to vehicles in order to win fees, despite knowing that risks were building in the underlying subprime mortgages. He raised particular concern that the same mistakes will be made unless more structural reform is undertaken. Change will happen but the incentive scheme will probably force things to change back to the obvious current scheme. Proposed alternatives included removing the regulations that require deals/vehicles to obtain ratings or suggesting that prospective purchasers pay for the rating rather than the seller.

9. ***Social impact investing***

The session was led by Brian Bailey, from PIRC Ltd, and Councillor Kieran Quinn, Chair of LAPFF, who began with a definition of Social Impact Investment as "Use of repayable finance to produce social as well as financial returns. Social returns result in improved outcomes for individuals and communities particularly amongst less well-off groups, e.g. improved health and wellbeing, higher levels of employability, reduced social problems and improved environment".

LAPFF commissioned the Smith Report which surveyed the opinion of a small number of pension funds; explored the reasons pension funds do not invest in social impact investment, tested the demand for such investments, identified key opportunities and barriers and made recommendations on what stakeholders might do to enable changes in practice. The recommendations of the report were better information and clearer guidance; demonstrate case studies and training to match impact investing with fiduciary duties, legislative changes and the creation of opportunities for investment.

As a consequence the five funds together, under the banner of the I4G initiative, invited asset managers to submit proposals that could meet an impact investing brief. The brief required asset managers to demonstrate they had an institutional quality product by providing information covering their good standing, experience, investment process, risk management arrangements, operating structure, fees, costs etc. In addition, to provide details of the impact of their investment activity identifying economic, social, environmental and geographic (in terms of deprivation and fund operating areas) impacts.

Although initially there were over 30 submissions by managers a number of challenges to the investment opportunities have arisen, namely;

- Opportunities come from relatively small investment funds resulting in relatively higher fees
- High relative supervision costs by pension funds due to small scale of investments
- Need to create a portfolio of investments in order meet risk management requirements and improve value for money (i.e. a fund of fund approach)
- Unfamiliar nature of some activities, asset managers and key personnel
- Categorising and evaluating the impacts
- Risk of being first
- Identifying an asset allocation and compliance with the fund's SIP
- Co-ordination of the 5 pension funds' due diligence and approval processes.

As a consequence to date only 7 propositions are in the detailed evaluation process which may lead to some or no investment opportunities, the outcome of which will not be known until early in the New Year.

10. ***Good Directors***

Jim O'Loughlin, PIRC Ltd chaired the next session, which began with Sacha Sadan, Director of Corporate Governance at Legal & General Investment Management, setting out the work he does with companies to improve the effectiveness of directors. L&G performs a highly active role in engaging with companies in which it invests, seeking to deliver the best possible long-term value for shareholders. Sacha's presentation concentrated on the essential qualities for a good director:

- Leadership
- Credibility and independence
- Listens to stakeholders
- Talent
- Thinks like an owner
- Being accessible
- Receptive to information/challenge

The outcomes from this work are sustainable returns, longevity (fewer turnovers of directors), strong succession pipeline, better able to navigate competitive environment, good relationships with stakeholders and lower costs of capital for companies. Sacha set out the framework L&G use for Directors, including majority of board independence, Chairman/CEO role split, annual re-election of directors, limiting the number of directorships held, external evaluation of the Board every 3 years and Lord Davies' targets for diversity, set out below:

- All heads of FTSE 350 companies should set out the percentage of women they aim to have on their boards in 2013 and 2015
- FTSE 100 boards should aim for a minimum of 25% female representation by 2015
- Each year, quoted companies should be required to disclose the proportion of women on the board, women in senior executive positions and female employees in the whole organisation
- Company bosses should disclose meaningful information about their firms' appointment processes and how they address diversity in annual reports
- Recruitment firms should draw up a voluntary code of conduct addressing gender diversity and best practice covering FTSE 350 board level appointments

In responding to questions, Sacha explained that it was important that company boards also listen to their employees, however, that does not necessarily mean employees have to sit on company boards. In addition, companies should reward all employees for company achievements not just the few at the top. Sacha indicated some companies had raised issues on who would conduct external evaluation, however he was determined that standards should be set for these reviews and boards should conduct internal reviews of their effectiveness etc. more regularly.

Tom Dobell, M&G Recovery Fund, explained their approach, setting out the companies that they invest in, particularly looking for unloved companies, ensuring the problems are transitory or solvable and taking a long-term view. Tom concentrated on explaining the direct involvement they have with company Chairmen and independent directors.

The Chairmen that run the Board should have the appropriate profile, strike the right balance of involvement, determine the corporate culture and assess and challenge the Chief Executive. Independent directors should have complementary skills through their breadth of perspective and experience, demonstrate commitment ("don't walk when the going gets tough") and the right chemistry to be supportive but challenging when required. Tom then used an example of their work with Easyjet which had both public operational and boardroom problems. Tom indicated that M&G were instrumental in allowing the new management team to be introduced in 2010 and they worked closely with other shareholders and the new management to develop the business. This resulted in a turnaround of the business, with increased profits and the introduction of dividend payments. Throughout Tom's presentation he stressed that the most important factor that defined a good director and chairman was trust.

Deborah Gilshan, Corporate Governance Counsel for RPMI Railpen Investments, concluded the session by explaining Railpen's direct company engagement and market policy work to address corporate governance risk and improve shareholder rights in the markets in which Railpen invests. Her examples were drawn from the USA where director accountability and board structure is behind the UK and where no codes of governance exist.

11. ***Climate risk: stranded assets, fracking and CapEx challenges***

Craig Mackenzie, Head of Sustainability, Scottish Widows Investment Partnership, began the session with the fact that it is estimated that 15-20% of Pension Fund equity holdings is in the fuel sector, consequently, climate change policies are very important to pension funds, as they pose a huge long-term risk to fossil fuel revenues.

Craig indicated that coal producing companies in the USA are seeing their share price fall drastically as they move to shale gas. In addition, analysts believe demand for coal in China will peak soon and the overall feeling was that World demand for oil will peak in 2020. As a consequence, with the cost of production varying across the World, as demand for oil falls those areas with low cost of production such as Brazil and the Middle East, oil production will remain profitable, whereas in the USA, where the cost of production is high, will see oil extraction reduce; leading to potential 'stranded assets'. As a result there is a need now to engage with companies in the fuel sector to understand individual company positioning against this demand risk, as their capital expenditure strategy will follow this fossil fuel future cost-curve and the need to understand their diversification strategies.

In the opposite corner, was Sarah Telik, a senior vice president of Apache Corporation, who was sceptical with Craig's analysis on the future demand for fossil fuel. She didn't deny it would happen, more so the timelines as to when it would transpire. She then explained that major oil producers only include proven oil reserves in their accounts; those reserves that have been proved to exist and the cost of extraction can be reasonably estimated, which is different to possible or probable reserves. Hence, company accounts would never be affected by the 'stranded assets' issue, although there is real concern over being able to replace these assets once they have been used.

She went on to explain that alternatives to fossil fuels can be more expensive due to equipment and technology costs, and China's rush for reserves is more a geopolitical desire to hold reserves (not all proven) rather than to achieve a rate of return, which distorts the market. She gave a robust defence to the effect of climate change and also indicated that coal prices were falling in the USA prior to the expansion in shale gas production.

Sandwiched between these counter arguments Faith Ward, from the Pension Fund Management Team in the Environment Agency, explained the EA involvement in industry wide initiatives to improve standards in responsible investment. Faith outlined the implications of the 'Green Light Report' launched by ShareAction in October 2013, which aims to assist pension funds by guiding them through the financial implications of climate change and the steps they can take in light of the risks and opportunities it presents. Taking a holistic approach, the report examines the following four key areas:

- Setting internal frameworks for managing climate risks
- Addressing carbon intensive portfolios
- Investing in a low carbon future
- The role of public policy

In essence it asks pension funds to have a policy and provide training on carbon risk, to evaluate carbon risks in their portfolios, to challenge capital allocation of underlying hydrocarbon companies and to look to low carbon alternatives.

12. ***Councillor Kieran Quinn – Chair of LAPFF***

With the overnight news of the death of Nelson Mandella the second day began with a moment of reflection, led by Cllr Kieran Quinn and Cllr Peter Brayshaw, London Borough of Camden, on the life of and their personal experiences of meeting Mr Mandella.

13. ***Media standards debate***

This session commenced with Martin Hickman, formally a journalist with the Independent, who is now reporting on the phone hacking trial for the campaign group Hacked Off. With Tom Watson, he is author of the book on the phone hacking scandal, Dial M for Murdoch: News Corporation and the Corruption of Britain.

Martin began by the re-telling of the phone hacking story, why it mattered and what can be done to prevent it happening again. He re-iterated that it was more than just phone hacking and covered more of unethical behaviour and corruption of public officials. This had caused huge harm to individuals and major corporations, and struck at the heart of public confidence since the press were seen as the police of last resort. A recent public survey indicated that corruption in the media is considered high which in the current climate of bankers is quite significant. Tom was obviously in favour of tighter press regulation, moving from the current arrangement of the club of editors through the PCC to Lord Leveson's view of independent regulation.

Dr Evan Harris, former Liberal Democratic MP and now representing the campaign group Hacked Off, continued with the theme set out in Tom's speech. He thought it ironic that owners of newspapers, who regularly argue for tighter regulation and standards for bankers and doctors, should think this does not apply to them. In his view the tighter regulation process would protect the public and journalists and would provide newspapers some level of protection from excessive legal claims if they accepted the proposed regulation changes. Sitting outside of this process would lead to higher legal claims/costs, as well as reputational risk, and make some newspaper companies insolvent. Hence, this was a corporate governance issue and one that shareholders, such as the LGPS, should be involved in by forcing these companies to accept the proposed regulations (which are still voluntary).

14. ***The future of the Local Government Pension Scheme***

This session was an open debate chaired by Brain Bailey, from PIRC Ltd, with Terry Crossley, former Deputy Director at the DCLG, and Councillor Kieran Quinn, Chair of LAPFF.

In response to a question on the sustainability of the LGPS, Terry indicated that the changes to the benefit system (CARE) was meant to be sustainable for the next 20 years, however employee rates should maybe have been higher to ensure sustainability and that the 2019 valuation may prove to be the most important valuation as April 2020 was the next opportunity to change the benefit structure. Kieran indicated there was continual uncertainty on cost sharing and contribution rates, as there is with investment returns, so there was always an issue of sustainability.

On the subject of the Scheme Advisory Board (SAB), Kieran felt it was probably too early to indicate whether this was proving to be effective. Both felt the role of the Pension Regulator was confused and this was high on the list of topics to be discussed by the SAB. There was concern raised on the increase in the number of employers in the LGPS and a potential that the SAB would be too remote from all employers in the various pension funds. Terry indicated that he felt with the SAB the danger was the Minister would be too far removed from local authorities and that new tensions would emerge if the SAB set too ambitious a programme of work. He went to on indicate that local accountability was paramount and felt Government does not understand the role of local councillors in managing the LGPS.

Expanding further on the issues of tensions between the Minister, SAB and local authorities, Terry expressed concern that HM Treasury's role added a potential additional tension with the setting of funding levels for all pension schemes, including the LGPS. He did not feel that the HMT had a desire to hold all the assets; however you can surmise that the desire to merge funds may be a step towards this.

On the specific issue of merging of funds, Kieran indicated that there had been over 130 responses on the call for evidence and the SAB were due to review these at a meeting before Christmas. Kieran felt the answer was more collaboration rather than merging. Terry's view was that merging was not necessarily the answer. If local government can make a success of collaboration and working together then the argument for merging disappears. Local accountability is important and who in their right mind would want to amass all the liabilities in 1 or even 8 big funds.

15. ***Investor collaboration***

A very short debate, chaired by Councillor Quinn, with Daniel Godfrey, CEO Investment Management Association, Janet Williamson, representing the Trade Union Shareholders (TUC), Richard Nunn, from the United Reformed Church and Chair of the Church Investors Group, and Amy Borrus, Deputy Director of the Council of Institutional Investors (USA).

Daniel Godfrey began by setting out the work of the Investor Forum, with the aim to work with companies to improve investor outcomes and move from short-term towards long-term thinking. There was a circle of virtue of those with capital (investors), asset managers (fund managers etc.) and companies that ultimately would lead to increased long-term returns for the benefits to the various beneficiaries of funds. He explained the work of the Investor Forum had not been as expected since only 50% of the market is owned by UK investors so there was a need to work more closely with sovereign wealth funds and foreign investors. It was hoped that LAPFF members would join the Investor Forum over the next 12 months.

Janet Williamson explained how the TUC has taken more interest in shareholder activity and their aim for all union pension funds coming together to vote in line with trade union values at AGMs. There were initial tensions with fund managers not necessarily reflecting union values in voting so as a consequence the TUC has written guidelines for all fund managers to follow. Presently only 3 of these pension funds (including UNITE and UNISON) representing £1 billion of investments, manage their voting rights together but hopefully more will join in due course.

Richard Nunn explained how the Church pension funds have a collaborative agreement over governance, ownership responsibilities and on voting along shared ethical values.

Amy Borrus' speech concentrated on the differences between the USA and UK on these issues and indicated that the UK leads the way on shareholder engagement and improving company governance. The Council of Institutional Investors was formed in 1985 and has grown to over 120 members representing both corporate and public pension funds, as well as some union and endowment investors; with a mix of voting and non-voting members (8 of the non-voting members are from the UK). In total the organisation represents over $3 trillion invested in USA companies. All members share fund similarities, such as long-term investor horizons and indexing strategies. Amy ran through the history of governance issues in US companies and the impact collaboration of institutional investors has made on improving corporate governance, increasing financial oversight and setting out the responsibilities of Directors and Boards of Companies.

16. **Investor Capitalisation**

The conference concluded with a lively, if not relatively short speech, by Lord Myners, Chairman of Cevian Capital (UK) LLP. This started with the comparison between the tyranny and voting system in North Korea to the Chairman's powers in UK companies and the process of election for a successor Chairman. Various committees have reviewed company governance, from Cadbury, with no discernible changes. Most of the issues arise because of the diversified ownership. In the 1970s fund managers would have had between 20-25 stocks in a portfolio whereas now this has increased to typically over 200.

He went on to suggest that managing fund manager's relative performance to benchmarks is an illusion as it does not reflect risk or how your money is managed. He also indicated that the term of underweight means they suggest the marketplace will do worse than a randomly chosen mix; and you pay them a fee! It is nonsense to suggest they will engage with companies if you are managing performance on 90 day reviews unless you are using these to manage fund manager's longer term performance. Basically his argument was against short-termist investment as fund managers will concentrate on the return you want rather than good corporate governance.

Lord Myners then turned to the work of the Investor Forum. His comments were that it was staffed part time, was late in forming and had planned funding for only 2 years. Although its aims were laudable he was sceptical that it would improve governance, especially as it is backed by investment managers.

He concluded his speech by indicating that LGPS investors do not have enough information to engage with fund managers, to beat them up on performance or to ensure they are doing work on improving corporate governance. Nor did he feel collaboration on voting was the solution.

Statutory and Policy Implications

17. This report has been compiled after consideration of implications in respect of finance, equal opportunities, human resources, crime and disorder, human rights, the safeguarding of children, sustainability and the environment and those using the service and where such implications are material they are described below. Appropriate consultation has been undertaken and advice sought on these issues as required.

RECOMMENDATIONS

1) That it be noted that attendance at key conferences is part of the Fund's commitment to ensuring those charged with decision-making and financial management have effective knowledge and skills.
2) That the report be noted

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Background Papers
None