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Glasgow City Council

Strathclyde Pension Fund Committee

Report by Head of Audit and Inspection

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Item 6

5th June 2019

**INTERNAL AUDIT – DIRECT INVESTMENT PORTFOLIO GOVERNANCE
ARRANGEMENTS**

Purpose:

To present the results of the Internal Audit review of the Direct Investment Portfolio governance arrangements within the Strathclyde Pension Fund Office.

Note:

In most cases one of four opinions is expressed:

1. The control environment is satisfactory i.e. audit testing found no concerns with the control environment.
2. A reasonable level of assurance can be placed upon the control environment i.e. audit testing found no major weaknesses in the control environment but some improvements could be made.
3. A limited level of assurance can be placed upon the control environment i.e. improvements are necessary to ensure the control environment is fit for purpose.
4. The control environment is unsatisfactory i.e. significant improvements are required before any reliance can be placed upon the control environment.

Recommendations:

The Committee is asked to note the contents of this report and **AGREE** the audit recommendation that the Head of Audit and Inspection submits a further report to Committee on the implementation of the actions contained in the Action Plan.

Ward No(s):

Citywide: ✓

Local member(s) advised: Yes No consulted: Yes No

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Strathclyde Pension Fund Office Direct Investment Portfolio governance arrangements – phase one review

1. Introduction

1.1 As part of the agreed Internal Audit plan we have carried out a review of the governance arrangements in place for the Strathclyde Pension Fund Office (SPFO) Direct Investment Portfolio (DIP).

1.2 The DIP was created in 2009 with a broad remit to invest in assets for which there was an attractive investment case but to which the current structure did not provide access. The strategy, management arrangements and capacity have been reviewed at regular intervals since then. As part of the actions arising from the 2018/19 Business Plan, it was agreed that the DIP should be reviewed during 2018/19. A report which summarised the findings of the review was presented to the Strathclyde Pension Fund Committee in December 2018. The Committee approved the recommendations from the report which included some changes in relation to the management arrangements and capacity of the DIP, namely:

- Approval to progress co-investment opportunities;
- Changes to the target Net Asset Value allocation;
- Updated minimum and maximum investment amounts;

- Amending the headroom capacity to a target allocation (5%) within a range of values (2.5% to 7.5%); and
- Changes to performance measures (the introduction of the Consumer Price Index as a performance measure).

Currently, within the DIP, there are 37 fully committed DIP investments with an approximate net asset value of £724m.

1.3 The scope of the audit was to gain assurance that there are adequate frameworks in place to support changes arising from the output from the SPFO review of the DIP and to manage DIP cash-flows (i.e. drawdowns etc.). The audit will involve a phased review. This report reflects the findings from the first phase and is primarily focused on the output of the DIP governance review referred to above. The second phase of the audit will focus on assessing the risk and managing the concentration of investments in relation to co-investment opportunities.

1.4 The scope of the audit included a review of the arrangements for:

- Managing the revised Net Asset Value allocation, investment limits and headroom limits;
- Monitoring and reporting on the performance of the DIP; and

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- Monitoring the cashflows of the DIP, including the management of drawdowns.

2. Audit Opinion

2.1 Based on the audit work carried out, assurance can be taken that the control environment is satisfactory. The audit has identified some scope for improvement in the existing arrangements and one recommendation which management should address.

3. Main Findings

3.1 We are pleased to report that the key controls are in place and generally operating effectively. We found that arrangements are in place to monitor and report on Net Asset Value (NAV) allocation and investment limits for DIP investments to provide assurance that the limits in place are not being breached. The performance of individual DIP investments is mainly measured on the basis of Internal Rate of Return (IRR) and arrangements are in place to identify and take forward any issues in relation to individual DIP investment performance. We identified that a new benchmark measurement was introduced for the total fund (which includes DIP) from the quarter ended 31st March 2019 and arrangements are being put in place to ensure that comparative performance based on the previous benchmarking arrangements are adopted for the first quarter's

reporting to help ensure that performance can be properly assessed. Arrangements were also found to be in place to monitor and manage cash-flows and drawdowns for DIP investments.

3.2 However, our audit testing found one area where the controls could be improved. We identified that there is a process to monitor the headroom limits, however adherence to headroom limits is not included within the current reporting arrangements that are in place.

3.3 An action plan is provided at section four outlining our observations, risks and recommendations. We have made one recommendation for improvement. The priority of this recommendation is:

Priority	Definition	Total
High	Key controls absent, not being operated as designed or could be improved. Urgent attention required.	0
Medium	Less critically important controls absent, not being operated as designed or could be improved.	0
Low	Lower level controls absent, not being operated as designed or could be improved.	1

3.4 The audit has been undertaken in accordance with the Public Sector Internal Audit Standards.

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- 3.5 We would like to thank officers involved in this audit for their cooperation and assistance.
- 3.6 It is recommended that the Head of Audit and Inspection submits a further report to Committee on the implementation of the action contained in the attached Action Plan.

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4. Action Plan

Title of the Audit: Strathclyde Pension Fund Office - Direct Investment Portfolio governance arrangements – phase one review

No.	Observation and Risk	Recommendation	Priority	Management Response
Key Control: Arrangements are in place to monitor revised NAV allocation, investment limits and headroom limits.				
1	<p>The SPFO is permitted to invest up to 30% of the total fund (the main fund plus the DIP fund) in limited partnerships at the point of investment. Although we identified that a process is in place to monitor the headroom limits in place to ensure that this limit is not breached, we found that adherence to headroom limits had not been included within the reporting arrangements in place. It should be noted that the current investment activity is well below the headroom limit.</p> <p>However, the lack of reporting increases the risk that the Committee are unaware of compliance levels in relation to investment headroom limits.</p>	<p>SPFO management should update the current reporting arrangements to include adherence to the investment headroom targets in place.</p>	<p>Low</p>	<p>Response:</p> <p>Accepted</p> <p>Headroom limits apply at the point at which a new investment is made. Going forward, any reporting that includes a recommendation to invest in a limited partnership will include the latest available value, in % terms, of total Fund that is invested in limited partnerships, as a means of monitoring continued adherence to the 30% headroom limit.</p> <p>Officer Responsible for Implementation:</p> <p>Chief Investment Officer</p> <p>Timescale for Implementation:</p> <p>June 2019</p>

5. Policy and Resource Implications

Resource Implications:

<i>Financial:</i>	Internal Audit services are included within the Central Support Services cost.
<i>Legal:</i>	None
<i>Personnel:</i>	None
<i>Procurement:</i>	None

Council Strategic Plan: To provide assurance on the controls in place in relation to the Direct Investment Portfolio.

Equality and Socio-Economic Impacts:

<i>Does the proposal support the Council's Equality Outcomes 2017-22</i>	Not applicable
<i>What are the potential equality impacts as a result of this report?</i>	No significant impact
<i>Please highlight if the policy/proposal will help address socio economic disadvantage.</i>	None

Sustainability Impacts:

<i>Environmental:</i>	None
<i>Social, including Article 19 opportunities:</i>	None
<i>Economic:</i>	None

Privacy and Data Protection impacts: None

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6. Recommendation

- 6.1 The Committee is asked to note the contents of this report and **AGREE** the audit recommendation that the Head of Audit and Inspection submits a further report to Committee on the implementation of the actions contained in the Action Plan.

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