PUBLIC ACCOUNTS COMMITTEE
THE STATES OF GUERNSEY

REVIEW OF THE INVESTMENTS OF THE STATES OF GUERNSEY COVER REPORT

Final Version

APRIL 2016

Content

1. Executive Summary

1.1. The States of Guernsey has over £2billion of public funds for which it is responsible. These funds are described in the "Summary of Balances" shown in the annual audited Statement of Accounts of the States of Guernsey and are made up of individual investment funds managed historically on behalf of the States of Guernsey by its Treasury and Resources (T&R) and Social Security (SSD) Departments.

1.2. The management of these funds has the potential to have a major impact on the overall fiscal performance of the States of Guernsey where an over-performance or under-performance of one per cent can represent plus or minus £20 million. With effect from 1st May 2016, responsibility for the management of these funds will transfer to the Policy and Resources Committee and the Committee for Employment and Social Security.

1.3. In 2009, the previous Public Accounts Committee (PAC) commissioned a review of the management by the States of Guernsey of its investments, in order to ascertain whether the States was investing its funds safely, whilst maximising returns for appropriate levels of risk. That review was undertaken by PricewaterhouseCoopers (PWC) and a summary of their recommendations is included as Appendix 1 to this report.

1.4. Given the importance and impact attached to the management of public funds, the current PAC considered that it was essential periodically to revisit this subject and to review progress. This latest review fulfilled that 'responsibility' and was carried out in two phases.

1.5. The first phase undertaken by the PAC's own Investment Panel with officer level assistance, concentrated primarily on the political governance arrangements in place within T&R and SSD in relation to the management of investments.

1.6. The second phase was undertaken on behalf of the PAC by BDO Limited and Broadstone Limited (to be subsequently referred to as BDO), who were asked to consider the performance of the funds invested. In particular, the review needed to provide an overview of the total funds invested by the States; whether investment returns might be improved by alternative management structures; the effectiveness of the existing arrangements in delivering the States' objectives; and the process for assessing risk, liquidity and benchmarking. A copy of the BDO Report is attached as Appendix 2 to this report.

1.7. The BDO Report concludes that "*the assets of the States of Guernsey are invested safely and securely, and that the overall risk and return characteristics of the assets are appropriate. We also believe that the current management structures are appropriate and give appropriate effect to delivering the States' objectives.*"

1.8. Notwithstanding the overall finding set out in the BDO Report, the PAC recommends that certain areas relating to the oversight and administration of the investment activities of the States are worthy of further review. Those areas are identified in this report and may be summarised as follows:

I. The political governance and oversight of the investment activities by both Departments;

II. Clarification of the investment objectives and assessment of the risk appetite of the different investment funds administered by the States;

III. Greater coordination of the administration of the investment activities by both Departments;

IV. Consideration of the definition of a consistent policy on responsible ownership and social and ethical investment; and

V. The investment of the non-utilised proceeds of the recent States' bond issue.

2. Political Governance

2.1. In the original review undertaken by PWC in 2009, a number of recommendations were made in relation to the political governance of the investment process undertaken by both the T&R and SSD.

2.2. In particular, PWC noted that in each department – *"The level of investment experience should be evaluated after any change in department board or election and appropriate action taken to ensure governance arrangements continue to be appropriate. This could include changes in the organisational structure and the amount of independent investment advice that is required"*.

2.3. PWC also noted that –*"the Departments should continue to cooperate, to share experience and to align investment operating and control procedures. They should also consider opportunities where aspects of the administration and management of investments can be centralised to achieve efficiency gains".*

2.4. The PAC's Investment Panel approached the task of reviewing the current political governance arrangements within each of the two relevant Departments, by interviewing key personnel involved in the management of investments and/or with responsibilities for the related governance.

2.5. Those interviewed included the States' Treasurer, the Chief Officer and Finance Director of the Social Security Department, along with those lead politicians within each Department charged with oversight of the investment function. The Panel also spoke at length with the investment advisers employed by each of the Departments from time to time.

2.6. The internal review also included a desk-top exercise looking at the relevant legislation, internal documentation, internal organisational structures, the internal reports produced in addition to the regular reports presented by each Department's Investment Consultant.

Findings

2.7. The arrangements that are in place within each Department in respect of political oversight of investments, although similar, have significant differences. Both political boards have nominated sub-committees to deal with those matters.

2.8. The T&R has established an Investment Sub-Committee with formally defined roles and responsibilities. It has also appointed a Non-States Member (NSM) to serve on that committee with relevant investment background, but who is not a member of the T&R board.

2.9. In the absence of a dedicated team of staff within the T&R, the Department places heavy reliance upon the support of its external Investment Consultant, using this support supplements the work of internal staff. However, at the time the review was conducted there was no formal framework in place to review the performance of the Investment Consultant on a regular basis.

2.10. The SSD has appointed specific Members of its board to assume oversight of its investment activities, one of whom effectively acts as lead political liaison on investment matters. The SSD appears to place less reliance upon its external Investment Consultant, notwithstanding that within the Department, investment activities are managed by officers in addition to their other non-investment related activities.

2.11. As the level of investment expertise that is available at political level, still cannot be guaranteed from one election to another, this continues to place significant reliance upon the continuity of key officers within the relevant departments who provide administrative oversight. The PAC is particularly concerned that the situation may be exacerbated when investment activities are undertaken by the newly formed Policy and Resources Committee. Given its wider mandate than the present T&R, it may not be able to dedicate adequate time and the resources necessary to oversee the management of the investments of the States of Guernsey.

2.12. This review has also made the PAC aware of the significant reliance placed by the political members of each of the relevant Departments upon the advice provided by its appointed Investment Consultant. Given the potential lack of investment expertise of elected political members within each Department, it is difficult to see any basis on which they might challenge or question that advice. This is of particular concern when political members of a board are asked to exercise oversight over the assessment of the appropriate levels of, or appetite for, investment risk and to determine the corresponding investment benchmarks set for such advisers. However, the PAC recognises that it would not be appropriate to impose another level of paid professional to exercise oversight of the existing Investment Consultants.

2.13. The PAC does however believe that there would be merit for the political members of each of the Committees who are to be involved in setting their respective investment policies and exercising oversight, to have access to an independent panel of professional experts. Ideally such a panel should be independent of the membership of either sub-committee and in addition, the term of appointment of the members of such a panel, should straddle political terms and be available to both of the sub-committees on a purely advisory basis.

2.14. The PAC recognises the potential value and continuity that can be provided by the appointment of a suitably experienced investment professional as a member of each Department's Investment Sub-Committee. In this context, the Committee supports the recent appointment of such a person by the board of the T&R.

2.15. The PAC also recognises the need for an educational programme for each newly elected sub-committee covering its investment policies and functions. In this regard, the PAC fully supports the first recommendation contained in the BDO Report.

Conclusions

I. T&R should formally instigate an overview of its governance framework;

II. The level of investment experience should be evaluated after any change in department board or election and appropriate action taken to ensure investment experience continues to be appropriate to maintain the appropriateness of the governance arrangements;

III. The level of investment expertise within the departments should be developed further;

IV. A panel of professional experts, independent of the membership of either investment sub- committee should be constituted and made available to the political Members to provide impartial investment advice on a purely advisory basis;

V. An educational programme for all newly elected Investment Sub-Committee members covering each Department's investment policies and functions should be undertaken; and

VI. Scrutiny of the whole range of fees rather than just annual management fees (transaction costs for example), should be part of the ongoing governance arrangements.

3. Objectives and Investment Risk Appetite

3.1. BDO undertook a review of the process and methodologies employed by each of the Departments for the establishment and monitoring of the investment objectives and risk appetite. In section 2 of their report, they assess the objectives of the various separate investment pools managed by the T&R, the appropriateness of those objectives, asset allocations and performance monitoring. Section 3 of their review, includes a similar assessment of the "Common Investment Fund" managed by the SSD.

Findings

3.2. It is important to note the key finding by BDO as stated on page 6 of their report: "*We believe that the assets of the States of Guernsey are invested safely and securely, and that the overall risk and return characteristics of the assets are appropriate. We also believe that the current management structures are appropriate and give appropriate effect to delivering the States' objectives.*"

3.3. However, BDO notes that all funds have failed to meet their investment return objectives over the last five years, although performance has broadly been in line with the return target over longer time horizons, which is consistent with the mandates under which the long term investment funds are managed.

3.4. BDO believes that long term investment return expectations have generally fallen over time and that the long term investment objective presently set by the T&R may be optimistic. It is concerning to the PAC that this may lead to higher risk strategies in order to achieve the expected returns.

3.5. Revisiting benchmarks has not really been undertaken historically and the PAC questions whether it would be more appropriate for an independent external organisation to review the benchmarks on a regular basis although not necessarily as a reaction to each four year electoral cycle.

3.6. Notwithstanding the general level of comfort to be drawn from the BDO Report, the Report does identify certain areas that they deem worthy of potential review. These are summarised on page 7 and relate primarily to the review and potential clarification of the objectives and target returns for the various investment funds administered by both Departments.

3.7. In response to points raised by T&R on the content of their report, BDO questioned how the particular target returns for each of the Long Term and Medium Term Investment Reserve funds were derived. The derivation of those return targets remains less than clear. PAC believes that the appropriateness of those target returns should be clarified and reviewed.

3.8. The BDO Report also recommends that further work be undertaken by T&R to assess the impact of interest rate and inflation on the funding of the Long Term Investment Reserve, especially given that the States Superannuation Fund represents approximately 80% of that Long Term Investment Reserve.

Conclusions

I. The PAC fully supports and endorses the findings and recommendations in the review undertaken by BDO;

II. Given the reliance placed within the States of Guernsey upon the assumed level of investment return and the impact upon States' revenues of under-performance, the PAC questions the wisdom of continuing to use a long term return objective that is considered to be "optimistic";

III. The long term investment objectives presently set by both the T&R and SSD, should be regularly reviewed to ensure that the targets continue to be appropriate but not necessarily at the beginning of each new political term;

IV. The purpose of each fund, and strategy to achieve that purpose, needs to be formally documented;

V. The long term return target for the Long-term Investment Reserve and the Medium Term Reserve administered by T&R should be reviewed as BDO believes that the existing return targets are challenging;

VI. The investment objectives for the Common Investment Fund administered by SSD should be reviewed and clarified;

VII. The T&R Investment Sub-Committee should consider the risks of the investment strategy in relation to the liabilities of the States Superannuation Fund, in particular the Investment Sub-Committee should consider the impact of interest rate and inflation on the funding of the States Superannuation scheme and the extent to which it may or may not be appropriate to hedge those risks; and

VIII. The T&R Investment Sub-Committee should work with its Investment Consultant to assess the possible impact on liquidity of its investment funds (in particular the Medium Term Reserve and the Treasury Fund), under different scenarios.

4. Administration of the Investment funds by the two Departments

4.1. In the course of its review, the PAC Investment Panel questioned whether the maintenance of the segregation of the investment functions and the administration of those functions between T&R and SSD impacted upon the performance or efficiency of the overall investment of States' funds. The same issue was also considered by BDO.

4.2. The PAC recognises that there are a number of different structures that might be adopted for the investment of States' funds. One particular alternative that was reviewed by the PAC Investment Panel was the use of a pooled collective investment scheme with separate investment classes (as used by the States of Jersey).

4.3. Such a scheme is able to offer a variety of asset classes and investment objectives linked to the different investment sub classes. Each department of the States of Jersey can through its own investment adviser choose its own investment objective and target for the investment funds for which it is responsible through an exposure to one or more of the different investment classes within the pooled collective investment scheme.

4.4. Whilst there may be some benefits that might be derived from the adoption of such a scheme, the PAC Investment Panel was not persuaded that at present, those benefits would necessarily compensate for the costs and risks of implementing such a change (in particular given the limited administrative resources available to the T&R and SSD). The PAC does however suggest that the use of such an alternative structure should be kept under review.

4.5. The BDO Report also addresses the potential benefits that might be derived by combining the investment assets of both Departments. BDO acknowledge that the decision to effect such a combination *"is a complex one that needs to take into account legal and political issues as well as the merits from an investment point of view"*. At page 36 of their Report, they go on to identify that from a purely investment point of view, there would be benefits accruing from such a combination given that the investment objectives of both Departments are broadly similar. In the absence of such a full-scale combination the BDO Report does however recognise the potential to save on internal States' resources by providing shared internal resources for the Investment Sub-Committees of both Departments. Such a theme had been picked up in the PWC Report of 2009.

4.6. The PAC Investment Panel also considered the possibility of both T&R and SSD using a single investment Consultant rather than each having its own. The two Departments in March 2015 had commissioned Mr John Nugee of Laburnum Consulting Limited, to evaluate the risks and benefits of appointing a single investment adviser/consultant for the entire portfolio of investments of the States of Guernsey. He concluded that in order to reap the full benefits of using a single investment adviser/consultant, other governance changes in the States' management of its financial assets would be required.

4.7. Unless and until the States of Guernsey is prepared at a political level to contemplate a full integration of the responsibility and accountability of the management of the whole portfolio of the investments of the States under one Committee, the PAC would concur that there is no obvious benefit to be gained by the use of a single investment adviser/consultant. The BDO Report also endorsed the benefits of the two Departments retaining separate investment advisers, and they comment (at page 36) *"as we believe that alternative investment views and styles diversifies risk, and this more than compensates for the additional costs incurred"*; they also add *"As you would expect to diversify active manager risk through having more than a single manager, diversifying overall risk through separate advisers between the departments should be seen in a positive light."*

4.8. During the course of this review, SSD made an appointment of new investment advisers. The process that was adopted for such an appointment was influenced by the advice given by Mr Nugee in his March 2015 report and based on his earlier conclusion as regards the retention of separate investment advisers/consultants. PAC has no reason to challenge the process that was followed or the outcome.

4.9. The BDO Report identifies at pages 7 and 8 a number of further detailed areas for review broadly relating to the administration of the investment fund activity by each of the Departments.

Conclusions

I. There is little to be gained by using a single Investment Consultant for both Departments, and that the use of separate Investment Consultants with alternative investment views and styles, helps to diversify risk;

II. The PAC believes that both Departments should as a matter of some urgency, review the extent to which there is scope to use shared resources;

III. The T&R Investment Sub-Committee should consider more formally identifying and documenting the risks within each investment reserve and the steps to be taken to mitigate these risks (in a similar manner to that adopted by SSD);

IV. The impact of transaction and other fees should be included in the formal review of fees by both Departments;

V. A periodic review of fees should be undertaken to ensure that they remain appropriate and competitive;

VI. The T&R Investment Sub-Committee should consider preparing and maintaining a Governance Framework Document for T&R on a similar basis to the document prepared by SSD;

VII. Any existing or potential conflicts of interest should be disclosed at the beginning of each investment sub-committee meeting and recorded in the minutes;

VIII. The T&R Investment Sub-Committee should follow best practice guidance in implementing a forward looking investment business plan and that progress against that business plan is regularly evaluated in a manner similar to that used by SSD; and

IX. The internal resources available to manage the investments of SSD, should be reviewed and consideration be given to cross-departmental support with T&R.

5. Responsible Investment

5.1. The BDO Report makes reference to the lack of a formal policy on responsible ownership within T&R. This contrasts with the position within SSD where the position on Responsible Ownership is documented.

5.2. The expression "Responsible Ownership" includes not only the concept of ethical investment policy but also matters relating to the attitude of the individual investment managers engaged in the management of the States' investment portfolios towards the exercise of the role as shareholders in the companies in which the States is from time to time invested. The BDO Report makes a particular suggestion that the individual investment managers should identify compliance with the UK Stewardship Code and the United Nations Principles for Responsible Investment.

5.3. The BDO Report identifies that the SSD position on social and ethical investment is set out formally in that Department's Governance Framework Document for its Common Investment Fund. The BDO Report recommends that T&R should similarly formalise its own position on such matters (item 13 on page 8 of the BDO Report). The PAC believes that if there is to be a formal position on social and ethical investment, then it should be applied consistently across all investments of the States.

5.4. The BDO Report also suggests that the SSD position and by implication the T&R position (once adopted) should be made public. The PAC is of the view that any decision on social and ethical investment should not be considered in isolation but as part of a wider States' policy applicable to all activities of the States of Guernsey.

5.5. It should be recognised however that any commitment to the principles of social or ethical investment is a challenge and needs to balance the desire to maximise investment returns with concerns for environmental, societal and governance issues.

5.6. The PAC notes the recommendations set out as items 13 and 14 on page 8 of the BDO Report, but itself makes no recommendations on these items.

6. Investment of the States of Guernsey Bond issue

6.1. The PAC recognises that the circumstances relating to the issuance of the bond issue may properly be the subject of a separate Scrutiny Management Committee review, however the use of the proceeds and in particular the investment of that part of the proceeds that have not yet been utilised for their intended purpose (the refinancing of existing borrowing by the various states trading entities) is a matter that is considered to be relevant to this present review.

6.2. A significant portion of the proceeds of the bond issue remains with T&R and requires to be invested unless or until it can be utilised to provide a new source of funding to the States trading activities. The return (or lack of return) achieved on those proceeds when compared with the costs of servicing the interest charges on the principal amount and the implied costs of the bond (approximately £14.6 million) is naturally of concern to the PAC. The risk of a mis-match between the cost of servicing the bond and the investment return achieved on the bond proceeds has been acknowledged by T&R.

6.3. The PAC Investment Panel is concerned that T&R has not yet addressed the issue beyond the short term expediency of a random allocation of those proceeds between the long term and medium term investment funds. The objectives and targets of those funds are however unlikely to be appropriate and should not be regarded as a long term solution to the problem. The revenue cost to the States arising from such a mis-match is likely to continue to be significant. The PAC recommends that the new Policy and Resources Department should conduct an early review of the strategy to be applied to the investment of the unutilised portion of the bond proceeds.

Appendix 1 – Recommendations from the 2011 Report

States Wide Recommendations

1. The list of permitted investments should be reviewed and revised to better define the type of financial instrument or investment vehicle and the associated risk, for example, although investments in hedge funds are subject to an overall limit of 10%, there are no restrictions on derivative instruments or stock lending. In addition, it is recommended that the list of permitted investments and limits is reviewed and updated on a regular basis.

2. A mechanism should be established to monitor exposure to investment risk on a States wide basis.

3. The States should consider establishing a cross department investment sub-committee with responsibility for the management of investments, reporting to both department boards. We envisage that this sub-committee could comprise of representatives of the existing department boards or other States members who have relevant investment experience and supplemented by independent expertise, such as the investment adviser.

4. The States should define the permitted investments of the General Revenue Cash Pool, or at least approve the investment guidelines currently in operation.

5. Consideration should be given to ensuring that all investment custodians are independent of investment managers. However where this is not the case, enhanced ongoing due diligence procedures should be performed by the departments.

Department policy level recommendations

6. The level of investment experience should be evaluated after any change in department board or election and appropriate action taken to ensure governance arrangements continue to be appropriate. This could include changes in the organisational structure and the amount of independent investment advice that is required.

7. The departments should continue to cooperate, to share experience and to align investment operating and control procedures. They should also consider opportunities where aspects of the administration and management of investments can be centralised to achieve efficiency gains.

8. Department boards should be fully aware of the underlying risks of stock lending and collateral pools should only be invested on terms that are consistent with the departments existing investment guidelines and risk appetite.

9. T&R should continue to perform long-term cash flow forecasting for the General Revenue Cash Pool and should review the current investment strategy if it is identified that there is a lesser requirement for liquidity.

10. The liquidity needs of the States trading entities and third party depositors should be factored into the cash flow forecasting for the General Revenue Cash Pool and reflected in its investment strategy.

Control procedure recommendations

11. Both departments should ensure that they receive SAS70 or equivalent reports from all outsourced investment managers and custodians. These reports should then be reviewed by an appropriate individual within each investment team and any issues identified and conclusions reached reported to the board. In the event that no SAS70 or equivalent is available, the boards should make a formal assessment of the organisation at least annually.

12. SSD should consider using the custodian's compliance system to enhance their monitoring of their investment managers mandates.

13. Both departments should request and evaluate Global Investment Performance Standards reports from their investment managers.

14. States wide minimum standards of due diligence should be set out for the assessment of service organisations providing outsourced investment services.

15. Where relevant the departments should monitor performance fees paid on gains not yet realised where those gains are subsequently reversed. This will enable a proper assessment of the performance of that investment manager.

16. Where common service providers are used, the departments should review agreement terms to ensure they are consistent and that they provide the best overall value for money for the States.

17. T&R should ensure that agreements are in place with all parties from which deposits are accepted which reflect the full terms of the arrangement.

18. The financial statements of the States should disclose (not applicable to SSD):
    (i) Investment management expenses separately from interest income to provide consistency between the General Revenue, Contingency Reserve and Superannuation Fund; and
    (ii) Internal reallocations of interest received separately from interest payable to third parties.

Appendix 2 – BDO / Broadstone review of the investments of the States of Guernsey

Link to Report

http://theoldsite.gov.gg/pacpublishedreports