The Scottish Parliament
Pàrlamaid na h-Alba

Official Report

LOCAL GOVERNMENT AND REGENERATION COMMITTEE

Wednesday 29 April 2015

Session 4

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LOCAL GOVERNMENT AND REGENERATION COMMITTEE

13th Meeting 2015, Session 4

CONVENER

*Kevin Stewart (Aberdeen Central) (SNP)

DEPUTY CONVENER

*John Wilson (Central Scotland) (Ind)

COMMITTEE MEMBERS

*Clare Adamson (Central Scotland) (SNP)
*Cameron Buchanan (Lothian) (Con)
*Willie Coffey (Kilmarnock and Irvine Valley) (SNP)
*Cara Hilton (Dunfermline) (Lab)
*Alex Rowley (Cowdenbeath) (Lab)

*attended

THE FOLLOWING ALSO PARTICIPATED:

Chad Dawtry (Scottish Public Pensions Agency)
Richard McIndoe (Glasgow City Council)
Peter Morris (Tameside Metropolitan Borough Council)
Bryan Smail (Falkirk Council)
Dave Watson (Unison Scotland)
Barry White (Scottish Futures Trust)
Steven Whyte (Aberdeen City Council)

CLERK TO THE COMMITTEE

David Cullum

LOCATION

The David Livingstone Room (CR6)

Scottish Parliament

Local Government and Regeneration Committee

Wednesday 29 April 2015

[The Convener opened the meeting at 10:00]

Decision on Taking Business in Private

The Convener (Kevin Stewart): Good morning and welcome to the 13th meeting in 2015 of the Local Government and Regeneration Committee. Tablet devices and mobile phones should be switched to flight mode because they may otherwise affect the broadcasting system. Some committee members may consult tablet devices during the course of the meeting, as we provide papers in digital format.

We have received apologies from Cara Hilton.

Our first item is a decision on whether to take item 3 in private. Are we all agreed?

Members *indicated agreement.*

Budget Strategy Phase 2016-17

10:00

The Convener: We move to item 2. Clare Adamson wants to declare an interest.

Clare Adamson (Central Scotland) (SNP): I declare an interest in that my husband and I are members of the Strathclyde pension fund.

Willie Coffey (Kilmarnock and Irvine Valley) (SNP): I am also a member of the Strathclyde pension fund.

Alex Rowley (Cowdenbeath) (Lab): I am a member of the Fife pension fund.

John Wilson (Central Scotland) (Ind): I think that I am a member of a local government pension fund, although I am not completely sure of that, and my wife is a member of the Strathclyde pension fund.

The Convener: Thank you for those declarations.

The second agenda item is oral evidence from two panels of witnesses on our mainstream consideration of the budget strategy phase 2016-17. In this session, we will investigate further an issue that we identified in our report to the Finance Committee in December 2014 on the 2015-16 budget—the role of local government pension funds in investing in delivery of local capital infrastructure.

I welcome our first panel of witnesses, who are Chad Dawtry, director of policy at the Scottish Public Pensions Agency; Barry White, the chief executive of the Scottish Futures Trust; Dave Watson, Scottish organiser with Unison Scotland; and Peter Morris of the greater Manchester pension fund and head of pension policy at Tameside Metropolitan Borough Council.

I declare an interest as a member of Unison.

Witnesses do not wish to make brief opening remarks, so we will move straight on.

What are the overall investment strategies of local government pension funds and how does investment locally in capital infrastructure fit into those? Mr Morris—would you start, please?

Peter Morris (Tameside Metropolitan Borough Council): Most pension funds invest about 60 per cent to two thirds of their money in companies and probably up to a third in loans and bonds. Most invest a relatively small proportion of their money in private equity and infrastructure. The upper limit in property is probably 10 per cent. We have invested very much along those lines.

Our local government pension scheme is based on an assumption by the Government that it will deliver a 3 per cent real return. One of the few ways in which we can get that return in the current environment is by expecting that equities will deliver real returns in the future. At the moment, we have bonds that are delivering negative real returns: it is really difficult to get anywhere near that 3 per cent.

Greater Manchester pension fund is a rarity in being at the high end of the scale of making local investments, and those investments have been growing over time. Our predecessor fund started to make a little private equity investment in the 1980s. Tameside took responsibility for the fund in 1987 and soon thereafter started trying to invest locally in property development. More recently, we have expanded quite a bit our local investment capability and capacity and the investments that we are making.

In my note, you will see mentioned the greater Manchester property venture fund, which is involved—as its name suggests—in investing in property development opportunities, and can invest up to 3 per cent of the fund in that activity. Our investment in housing, which involves homes for sale and market rent, has attracted a lot of interest. We are in the first stage of building 240 homes.

We also have a local impact portfolio, which can invest up to £150 million. We have a variety of means by which we invest locally, and we do so on two premises: first, the investment must have commercial returns and, secondly, it must have some added benefits for the area.

The Convener: Mr Dawtry, do you want to talk about the Scottish perspective?

Chad Dawtry (Scottish Public Pensions Agency): The Scottish Government does not hold records on exactly where each of the 11 pension funds invests its money. As I say in my submission, on 1 April new governance arrangements came into effect that require a scheme advisory board. The first meeting of that board is tomorrow; it will consider a number of issues around its work plan, one of which is transparency about where funds invest their money. At the moment, however, the Scottish Government does not have central sight of where that money is invested.

The Convener: Does the Scottish Futures Trust have a view, and could you benefit from pension funds investing in local infrastructure?

Barry White (Scottish Futures Trust): I think that Scottish infrastructure and the Scottish economy could benefit from a more active investment style on the part of pension funds. The paper from Manchester summed it up, in saying that it is not an either/or question in terms of commercial returns. It is a case of seeing whether you can get a double bottom line whereby you get a commercial return and can also take advantage of local investment opportunities.

There is a paper from Unison on housing. With additional investment, housing supply could present a good opportunity for pension funds while also helping the wider economy. There are areas beyond that: opportunities certainly exist.

The greater Manchester pension fund paper highlights some of the risks of that approach. There is a capacity and capability issue in moving to more active management of investment rather than working through third parties, because the funds have to work in a hands-on fashion, so governance and capacity in teams probably need to be different.

The Convener: How different do they need to be?

Barry White: If a fund is to invest locally, it will need more hands-on expertise. For example, the universities superannuation scheme, which is headquartered in London but covers all the United Kingdom's universities, has an in-house infrastructure investment team, through which it has bought stakes in NATS Ltd—the air traffic control service—Heathrow Airport Holdings Ltd and so on, and has put people on the boards of some of those companies, too. Like some of the big Canadian pension funds, its style is to make direct investment, rather than to go through third-party funds, and actively to help to manage those investments, too.

Overall, as the Manchester paper says, in assessing things such as property or housing transactions, it is necessary to take a more hands-on approach than when management is outsourced, which involves simply monitoring the performance of the fund. There are bigger decisions to be made when in investing locally.

Dave Watson (Unison Scotland): Our interest came partly as a result of the new governance arrangement that Chad Dawtry has just mentioned, but also through negotiating the new pension scheme that comes into force this month. When we saw—probably for the first time—an aggregate of where the money is being invested in Scotland, we noticed that almost half the investment is in overseas equities and that another quarter is in UK equities, but that there is little investment in local infrastructure.

Our members want a return on the investment to pay their pensions—that is my primary job as lead negotiator for the pension scheme—but obviously they would prefer that investment to be made in things that are useful to them. There was also a concern that equity investments were costing a lot in hidden management costs. We have commissioned quite a lot of work on that, but it was another driver to look at different methods. As one member put it to me at a meeting, "My pension fund invests in the Tokyo underground, but not in the 'Clockwork Orange', which I go to work in every day." That might be a simplistic description, but I think that it reflects a reasonable local view.

As a result, the Scottish Federation of Housing Associations and I got together to look at housing as an example. The committee has the resulting submission, but I do not think that the issue is just about housing. In the paper, we used the example of housing to stimulate discussion on the matter. That has happened to a degree; with the new governance arrangements, now is the time to take that forward. There are some constraints that I am sure the committee will want to explore, and I am happy to cover them in further questions.

The Convener: Thank you.

We have heard that local investment in areas such as housing might require more hands-on support by the funds to ensure that the investment is managed wisely. Has that been the Manchester experience? If so, what additional resource has been required to ensure delivery of infrastructure projects?

Peter Morris: Our local investments and property team currently has eight people. At the moment, they are looking after a very small proportion of our fund, but it will grow to 5 per cent of fund value. The other 95 per cent is looked after by a team that has only one more member of staff.

The Convener: So we are talking about teams of nine versus eight.

Peter Morris: Yes. We have consciously separated out the local investment team. There is, of course, a potential overlap—either way—when big transactions come our way, but the scale and demands of looking after local investments are, from our perspective, much greater than looking after our other assets, simply because we are more involved in them.

The Convener: With regard to the nine members of staff who are dealing with the other investments, how much money is spent on fund managers to deal with those investments? Are fund managers involved in delivery of local investment?

Peter Morris: We have an external manager for our property venture fund who sources, arranges and manages and is seeing through the development, but it still requires more of our involvement than anything on the main fund side. We do that because we get a reward from it.

In general, any relatively significant transaction that we take on involves our also taking on board representation with regard to the vehicles through which the investment is being managed. We either do the appraisal ourselves or challenge it more than we would in any other situation. With regard to the joint venture vehicle for housing, for example, the accounting for and administration of the vehicle are part of the activities that we carry out. I can give you more examples, if you like.

The Convener: You say that you have eight folk dealing with local investment and nine folk dealing with all the other stuff. However, in my experience, when there is a small team of folk dealing with the day-to-day business of the pension fund, there is often also a huge amount of outsourcing and payment to others to deal with aspects of the fund. You might have eight folk dealing with local investment and nine folk dealing with the other stuff, but it might well be that the overall costs of dealing with the other stuff are much greater, because you are using external sources to handle a lot of that work. That is what I am trying to get my head around.

Peter Morris: I will illustrate by referring to our investments in companies and bonds, in which case the cost of manager fees is appreciably less than 0.2 per cent. In our investments in private equity, management fees might well cost up to 5 per cent, depending on the success of the fund. The costs for local investments are more in line with the costs that are associated with private equity infrastructure funds than with the costs of investing in companies and bonds.

The Convener: Can you give us a percentage? You can think about it, if you like.

Peter Morris: Let me think about it.

10:15

John Wilson: A local government pension scheme advisory board was supposed to be established under the new rules that came into effect on 1 April. I picked up from Mr Dawtry's response to the convener that the advisory board's first meeting is to take place tomorrow, but as far as I am aware there has been no public announcement about who the board members are. Who makes up the board, where are they from and what experience do they have?

Chad Dawtry: I do not have to hand a list of all the members, but it will be published on the SPPA's website—in fact, it should already be there. The scheme advisory board is bipartite, by which I mean it comprises employer and employee representatives; the Scottish Government is represented by the SPPA in the capacity of observer. In effect, the scheme is being run by employers and members, and the member representatives have been nominated by unions.

John Wilson: What is the balance on the board? I am asking because, as I have said, the information has not been made public; indeed, I was quite surprised when you made the announcement. When I checked the Scottish Government website yesterday afternoon for an announcement, the only thing that I found was news that discussions were taking place about appointment of the board. The names of the board members have not been made public, so I just want to get an idea of the balance. Is it 40 per cent employers and 40 per cent employees, with 20 per cent Scottish Government representation?

Chad Dawtry: No. The representation is pretty much evenly split between employers, who are represented by elected members, and members, who are represented by trade unions. The Scottish Government does not have a formal seat at the table, but has observer status. Other people, for example advisers, can attend meetings, too.

John Wilson: I was interested in your comment that the Government holds no information about where pension investments are currently being made, and that there has been no analysis of that—at this point I thank Dave Watson and Unison for their analysis of where investments are being made. Will one of the new advisory board's major tasks be to find out where local government pension funds are being invested? After all, you will need that information in order to advise the pension funds on whether the advisory board would deem such investments to be appropriate.

Chad Dawtry: I will answer that question in two ways. First, it is probably not going to be a major task for the scheme advisory board. Obviously the board will have to look at a number of things; its predecessor, the Scottish local government pensions advisory group—or SLOGPAG—agreed what I would call a to-do list. It was not quite a work plan; we will start to turn it into such a plan at tomorrow's meeting.

As I have indicated, one of the areas that needs to be looked at is transparency about where the investments from the various funds are going. The Scottish Government has taken the view that we set out the framework within which the scheme operates—there are 11 funds, and they have delegated responsibility to manage within those regulations—but the scheme advisory board will certainly want to know where moneys are being put.

John Wilson: I want to come back to an issue that Mr Watson raised when he referred to the Strathclyde pension fund investing in the Tokyo rail network while failing to invest in local transport infrastructure in and around Strathclyde.

I am trying to pre-empt the first meeting, Mr Dawtry, but would the advisory board be looking to give clearer direction to pension funds—bearing in mind the fiduciary duties that apply to those pension funds—in relation to the possibility of investing in infrastructure projects within their own region or within Scotland?

Chad Dawtry: First, the Scottish ministers have been very clear about that. They see the advantages of investing in infrastructure, whether through the local government pension scheme or through any other pension scheme.

The scheme advisory board will need to consider the issue, based on the information that it gets about where the money is going, and do what the committee is doing here—look at examples of where things have worked well and at case studies to work out the possible opportunities.

John Wilson: I have mentioned Mr Watson a couple of times. Would he like to respond?

Dave Watson: Surprisingly, I would love to. The new scheme advisory board is bipartite, as Chad Dawtry said. It has a rotating chair and there are seven councillors and seven trade union reps. The Convention of Scottish Local Authorities provides the employer-side secretariat and I am the trade union-side secretary to the new board.

The paper that we are jointly taking to the first board meeting tomorrow includes a work plan for the new board. High up on that work plan is the need to address the transparency and consistency of information on investments. At the moment, there are really only two ways in which people can look at the information Scotland-wide. One way of doing it is at the time of evaluation. For the negotiations on the new scheme and the evaluations, the Government Actuary's Department tends to pull together the data so that we get a nice chart and can see where the money goes. However, that information is always a little bit out of date, in fairness.

The second way of doing it is through freedom of information requests, which are done by us, by journalists and by others. Frankly, it is not the best way to pull together information on £26 billion or £27 billion of investment, which is—or should be—a huge driver of the Scottish economy. Therefore, there is a broad understanding that we need to explore ways of having some consistency and transparency so that everyone can see where that money is being invested. Once we have that, we can start to discuss what advice and guidance we need to shift the balance of investment to those areas that employers and trade unions would wish to see it go to.

Barry White: We should be very careful. We should not criticise pension funds for investing in the Tokyo subway—although let us not pick on just the Tokyo subway. If that is a good investment, it is a perfectly valid thing for pension funds to do. It is about having a mix in the portfolio. Allocating part of the fund for local investment but managing that carefully would be a good thing. However, we should not be drawn into saying that investing in the Tokyo subway is wrong if it is a good investment and it is helping the fund to be successful. That is really important.

On transparency, one of the great challenges is that there are lots of infrastructure funds with lots of local government pension fund money in them. Those infrastructure funds are quite reluctant to declare who has invested in them, because that is their customer base and they do not want other infrastructure funds tapping up their customer base.

We know, for instance, that in Dumfries and Galloway, some of the subordinate debt for the new Dumfries and Galloway royal infirmary—a non-profit-distributing project—was put in by Aberdeen Asset Management through its infrastructure fund. From the papers, we know that Strathclyde pension fund is one of the investors in that fund. We would not necessarily have visibility of that information as part of the procurement team working with the health board for that project. I am delighted that Strathclyde is part of it but, equally, the Aberdeen Asset Management fund will invest across the UK and even abroad.

From that point of view, getting absolute transparency is more difficult. What Manchester has done very well is say, "Up to a certain limit of our fund, we will look to do some local stuff but manage that really carefully." I think that the figure is 5 per cent. That added transparency and added focus are really helpful.

John Wilson: NPD is a debate for another day. Barry White will note my recent parliamentary questions on the returns from some of the funding of NPD projects.

How many of the existing 11 local government pension funds in Scotland are investing in local or Scotland-wide infrastructure? The reason for the debate is to find out how best we can utilise the resources that are sitting there. The Tokyo underground is a good example. Although the Glasgow underground system needs major investment, what would be seen as Scottish trade union members' money, as Dave Watson said, is being invested in improving transport infrastructure in Japan. There seems to be a reluctance to use that funding to invest in infrastructure and transport projects in Scotland.

The Convener: We are talking about non-trade union members' money, as well.

John Wilson: Sorry.

The Convener: Does anyone have an answer to that?

Barry White: I do not have the answer to that specific question. As I understand it, the Glasgow underground is publicly owned. Pension funds can be invested in Tokyo's subway because somehow a private element of finance goes into that. Putting investment into the Glasgow underground is a question of two things: public powers of borrowing, given that it is a public asset; and how the investment is repaid. Either the fares have to go up or somebody else must pick up the tab for the borrowing. Even if any of the pension funds wanted to invest in the Glasgow underground, as currently structured, they could not, unless the Scottish Government or Glasgow City Council issued bonds to invest in it. However, those would be Government-backed or municipal bonds rather than an infrastructure-backed investment.

Because of the public nature of much of our infrastructure in Scotland, pension funds have limited opportunities to invest directly in our transport infrastructure.

The Convener: Before we get sidetracked, does anyone have the answer to the original question about how many pension funds in Scotland are investing in local infrastructure? No.

John Wilson: I am conscious that I am taking up a lot of time, convener.

The Convener: On you go.

John Wilson: Thank you.

Mr White, you talked about public versus private investment. Part of the dilemma that we face is how we square the circle and ensure that pension funds can be used for public projects. Let us take the example from more than a decade ago of local authorities' investment in the building of new schools throughout Scotland. The investment regime that was used did not involve public money; it involved public-private partnerships. The private finance initiative and PPPs were used to deliver those schools.

How do we get to a position in which we can use the pension funds to deliver public projects? If the difference is that Tokyo has a private rail network and the Glasgow subway is publicly owned, how do we get to a situation in which we can utilise what might be useful investment? You are saying that we face a difficult dilemma because of the difference between public and private investment.

10:30

Barry White: I suppose that there are a couple of quick answers to that. There is a bit about borrowing powers in the Smith commission proposals. The Scottish Government could issue bonds, which pension funds could buy. That is one part.

Under the complex classification rules, one of the only ways to get pension fund investment into public infrastructure is through NPD or PPP-type structures using project finance. That is what the accounting rules say can be done. I would therefore say that the areas to think about for pension fund investment are ones that involve some form of income stream other than one from the Government. Housing is a particularly attractive example, because there are tenants who pay rent. Energy efficiency and offshore wind are big areas that require private investment but which do not involve publicly owned assets. There is also commercial property in our big cities. All those examples could be very attractive opportunities for pension funds to invest in if they had an increased local focus.

As far as getting pension fund money into public assets such as schools is concerned, the only way that that can practically happen under the current accounting rules is through a project finance PPP or NPD-type structure.

The Convener: Mr Dawtry, do you have any idea of what percentage of pension fund money is invested in Scotland?

Chad Dawtry: Do you mean local government pension schemes?

The Convener: Yes.

Chad Dawtry: No. I think that I said that earlier. The Scottish Government does not hold that information. Dave Watson has helpfully given an estimate that has been worked out on behalf of Unison, but we do not have formal records on that.

The Convener: Is that one of the things that the new group will be looking at as part of its work programme?

Chad Dawtry: Yes. It will look at transparency of investments in general. That would include infrastructure as well as other areas.

The Convener: Mr Watson, will you put your estimate on the record, please?

Dave Watson: It does not tell us about Scotland. According to the most recent figures that we have, the UK estimate was that about a quarter of the money was going into UK equities. There is no way of breaking that down between Scotland and the rest of the UK.

The Convener: Okay.

Alex Rowley: Good morning. A lot of this seems quite complex. I have always found that, when you speak to finance people in local government or wherever, there are a lot of reasons why you cannot do something. I want to bring us back to the role that a political directive can play. Let us take the example of housing. We have a housing crisis in Scotland. At local government level there is a political directive that says that we need to build 50,000 houses over the next four or five years, and we need to fund that.

My question is, what are the barriers and how do we start to break them down? We should start from that point of view rather than by asking—as Mr White suggested in relation to the Tokyo subway—whether something is a good investment. That depends on how you measure “good”. There will be profit from investment in housing—there will be the profit that comes from guaranteed rents. I would say that we need to see council housing being built; because of housing benefit, the rent is guaranteed. The return might not be as big as it would be on investment in the Tokyo subway, but there will still be a return—for the social good, for communities and for housing.

Instead of trying to get round all the complex classification rules, we could have a political directive that said, “We want to invest in that.” We should be asking how we go about that and what the barriers are. Should that not be our starting point, instead of looking at all the complexities?

The Convener: We will go to Peter Morris first, as he seems to have managed to break down some of the barriers to investing in housing.

Peter Morris: In our fund, a 1 per cent investment return is worth 8 per cent of the total pay bill. As has been said earlier and as it says in my submission, to do local investment, you have to satisfy the twin aims of commercial returns and supporting the area.

I will briefly talk through the Manchester illustration. Manchester is just like any other area of the country in that there is a big shortage of houses. We did not go down the social housing route with Manchester, because we did not think that it was capable of delivering a viable return to us. Our pilot is 240 homes. The proportions for sale and for rent were driven by the target return that we were seeking. There is a little more risk attached with the sale option, because we do not know how much we are going to get or how quickly we will sell, but it produces a higher rate of return than the rental option. For us to get a viable return, the houses had to be for sale or for market rent.

We have a mixed range of sites. The reality is that some of the sites have a very high land value per plot and some might well have a negative land value per plot. We appraised the five sites together, and the return was based on all five sites added up. If a site has a negative land value, we literally have to give somebody money for them to build to make it work. One of the good things about what we did was that it meant that housing was built earlier than would otherwise have been the case and there was more of it. Manchester City Council could have sold the expensive site to a private developer to build homes on it. However, putting a range of mixed sites together enabled the aggregate to deliver a satisfactory return for us and for the council, which also reaped the benefits of more rates and the new homes bonus and all that goes with that.

On the way that the deal is structured, in effect, from our perspective, for a long time it is a bond, with a fixed-interest return. At the end of 21 years, we will get any equity returns that flow from it. There are four or five parties that are important to make the approach work well. Obviously, we have to get on well with the city council. We need good project management and technical skills. We need a good builder. As a pension fund, we do not want to be a direct landlord, so we need a tenant who will act as landlord for all the properties. As well as being a tenant, they are responsible for property management, so they will calculate what rent they think that they can get, then knock off the wage risk, the repair and maintenance risk and their bad debt risk. In effect, that gives a rent to us. The attraction of the rent is that it is linked to inflation, and it is a 21-year lease.

The 240 homes cost us £26 million, and there was the Manchester land value, which obviously was a reasonable sum in aggregate. The profits are shared on the basis of the land value relative to our investment. The sale prices obviously varied, depending on location, just as they would anywhere else. The houses that we built were similar; in fact, they were virtually the same in most locations.

The Convener: I take you back to the beginning of that answer, when I think that you said that there is more risk in dealing with the houses for sale than in dealing with the houses for rent. Is that correct?

Peter Morris: What I was attempting to say, although I did not say it sufficiently clearly, is that, with the rented properties, we have one tenant—it is a big registered social landlord—that is responsible for letting the 120 properties and ensuring that everything works. We know that that income is guaranteed and how it will move over the next 20 years.

In our financial model, we made assumptions about the number of homes that we could sell and the price that we could sell them for. Fortunately, because of the way that things are going, the housing market is working in our favour, so we are selling more quickly and prices are higher than expected. That will improve the financial returns from the project.

The Convener: We return to Mr Rowley's question. Mr Watson, do you want to comment?

Dave Watson: You will not be surprised to hear that I do not agree with Barry White on investing in PPP schemes, but I agree with him in that we are not saying not to invest in the Tokyo underground or anything else. It is a balance and the balance has got a bit out of skew when half the money goes abroad.

The key point about a good investment for pension funds is the word "investment". It is not free money; there must be a rate of return. Therefore, investments in things that have a revenue stream, such as housing, transport or energy—we are very keen on local authorities getting much more involved in local energy generation—make themselves more suitable for pension investment.

Alex Rowley asked about barriers. There are a number of barriers, one of which is that there is a conservatism about pension funds in general, and local authority pension funds are no different. They will say, "We've always done it this way," and they know about some things but are not so sure about others. That is closely linked to expertise. Pension funds know and understand equity investment. They understand commercial property investment pretty well, too, because they have a lot of experience in it.

When we talk to pension funds in the public and private sectors—I deal with both—they often say that they do not really understand social housing, do not have the expertise and are a bit nervous about getting involved in it, to which my answer is, "Well, get the expertise." In my view, one of the best-managed pension funds in the UK is West Yorkshire pension fund, which has an almost entirely in-house team and lots of expertise across the board. It is possible to develop the expertise to build social housing.

Another barrier tends to be a fairly conservative view of fiduciary duty. There have not been many legal cases on that. The worst one is probably the Cowan v Scargill case, which is pretty infamous. As we lawyers say, bad cases make bad law and that really was a bad case for bad law. There have been some more helpful views. The Local Government Association in England commissioned counsel opinion on fiduciary duty. That is a public document and quite a helpful description of how pension funds can be a bit more imaginative and not be too constrained by fiduciary duty. We must invest in the interest of the funds, but that does not mean that we cannot do a range of other things.

A final barrier, although I do not think that it has been a problem so far, is that there are obviously limits to the investments that are permitted under the Local Government Pension Scheme (Management and Investment of Funds) (Scotland) Regulations 2010. One of the things that we will want to consider in the scheme advisory board is whether there needs to be more flexibility in those investment regulations to give pension funds the ability to invest outwith the current constraints and to give some advice and guidance on issues such as fiduciary duty.

Barry White: Housing is a really good example. There are a number of ways in which we could increase housing supply quickly, but pension funds taking the lead on that will not help in the short term because they are not set up to do it at the moment.

The Smith commission is giving increased borrowing powers but I do not know where the schedule of increased borrowing powers sits. However, it could be possible for the Government to borrow money and, using public and other land, perhaps in a joint venture with the private sector, build housing at scale with a view to selling it to a pension fund-led company at some stage in the future.

Rather than waiting for the pension funds to develop the capability, we could develop a product that could be sold to pension funds. That could be done on a rolling basis. However, one of the things that stops that at the moment is the Scottish Government's limited borrowing powers.

The current rate of borrowing for the Scottish Government is about 2.4 or 2.5 per cent over about 20 years, and mid-market rent housing could be done very viably at that sort of cost of finance. If that was sold to a pension fund, its interest would probably be in having a higher rate of return than 2.4 per cent, because that represents a sovereign cost of borrowing. Nevertheless, it could still be viable. It might be necessary to have a mix of private rent and mid-market rent in such a development—which is probably quite a good thing to do anyway—to make it all stack up financially.

There are things that we could do to increase housing supply. Alex Rowley said that the discussion was quite complex. Housing is probably one of the most simple things. The variables on one side are the cost of land, the cost of building the house and the cost of finance. The rent or sale is the income on the other side.

The Government has an advantage in that it has a low cost of finance. Therefore, one of the things that we have done in the national housing trust is to use local authority borrowing cost of finance to make mid-market rent viable without any direct subsidy. That shows what can be done. With wider borrowing powers, more could happen in that regard.

10:45

I am not advocating either Government borrowing or PPP—I do not have any preference for either—but, in the NPD programme, £1.8 billion-worth of projects have reached financial close so far, and almost half the finance for that has come from pension funds and insurance companies. There are people investing institutional money into Scotland right now. A lot of it has come from outwith Scotland, in terms of where the funds are headquartered, but it is very hard to trace back to exactly where the pension funds are invested and to who invests in them.

That makes the point for me. If the right product is there, the pension funds will step up and put money in. Part of the challenge with housing is creating that product to invest in.

Chad Dawtry: I do not have much to add—investment specialities are not my area of expertise. My agency looks after the legislative framework and the design of five pension schemes. The local government pension scheme is one of those schemes. We ensure that the regulations and legislation are looked after.

To echo what colleagues have just said, I remind the committee, without overemphasising the point, that there is a fiduciary duty—and yes, there is a more liberal way of looking at that. The pension funds exist not to produce infrastructure but to ensure that pensions can be paid when they are due and when the liabilities fall due. As far as I am aware, none of the local government pension schemes is currently fully funded—all of them are less than 100 per cent funded.

Alex Rowley: A number of pension funds over the years have decided to consider ethical investment and not to invest in tobacco, because tobacco kills people. Directors of pension funds are able to make such decisions for themselves. People might not get as high a rate of return for investing in social housing, but we might argue that the social good of that is a much higher rate of return for the pension fund members. I am trying to work that out.

In my experience, the discussions take place at a level that most people do not understand and we never actually move forward, but I am trying to find a way to do that. Take Fife Council, for example. The council currently has a programme for building 2,700 houses. As part of that, it would have had to work out exactly how much would come in for those houses year on year. That is a guaranteed income. The council put up the rents by an additional 1 per cent, I think, to help finance that over that period. It went out and borrowed that money.

What is to stop us sending pension funds a political directive, from the Scottish Government and from local authorities, saying that we want to use pension funds to finance a major housing programme over the next 30 years?

The Convener: I would like to add something to that. The submission from the Strathclyde pension fund states:

> "The limits on partnership investments contained in the Local Government Pension Scheme (Scotland) (Management and Investment of Funds) regulations provide a particular impediment to further investment."

Is that one of the things that would prevent such things from happening?

Chad Dawtry: We covered that in the SPPA submission. The Scottish Government recognises that those limits need to be reviewed, and there might be a question mark over whether any limits are required. However, that will be for the scheme advisory board to decide.

The Convener: Is that high up the agenda of the new advisory board?

Chad Dawtry: Yes.

The Convener: That is key for all of us here to know.

Chad Dawtry: It is. The scheme advisory board could, for example, take an early view on whether there needs to be some short-term change to limits as part of a longer-term review of whether the limits are required at all. There is already a duty in the regulations—in particular, in regulation 11—that requires local government pension funds to have diversity in their portfolio.

The Convener: It would be very useful for the committee to get an indication after your first meeting, and probably after subsequent meetings, of your work programme, so that we can see clearly how you are setting about bringing down some of those barriers.

Dave Watson: As one of the joint secretaries, I am happy to give that assurance. It will be an issue for discussion at tomorrow's meeting about what the programme will be. We have put the draft in, and this issue is part of that.

Another issue in the work plan concerns other constraints, which I think that Alex Rowley touched on earlier. The investment regulations go back to a time when the view was that pension funds had to have fairly prescriptive constraints to stop them doing mad and crazy things. The world has probably moved on a wee bit since then and my personal view is that we could be a lot more flexible with guidance that says that the funds cannot do mad and crazy things rather than saying that they can invest only 5 per cent here or 10 per cent there, for example.

The annex to Chad Dawtry's paper summarises the current limits, which are fairly prescriptive. Given the current environment, we can ask whether we need to be that prescriptive to local authorities from the centre and whether there could be a more general duty of the sort that is found more commonly in the public sector. However, that does not get round the point that Alex Rowley raised about the constraints of fiduciary duty.

There is a complicated legal issue, which I will not bore you with, regarding the various people who are involved in the pension boards and committees—both councillors and our members—and their status as trustees, or not. It is fairly clear that there is a fiduciary duty, but we need to tease out its scope. Alex Rowley is quite right that pension funds have found ways in which to have views on environmental, social and disinvestment campaigns, fossil fuels and all sorts of things like that, but they do so in the context of their views not undermining the fund's financial viability. There is a scope within that that is not well understood, so we need to issue guidance and advice on that area. Again, that matter is being presented to the scheme advisory board tomorrow for some clarity.

The Convener: It would be extremely useful for us to get that work programme in order to see the things that you are working through. We will probably find later that although some funds have ethical policies in place, others do not because they have been told that that might have fiduciary implications.

Clare Adamson: I have a supplementary question on what we have just been talking about. I suppose that it is a general question for four members of the panel, but perhaps a very specific question for Mr Morris; it concerns the influence, if any, that they have been able to have on the procurement side of what happens once an investment has been made. For example, could an ethical policy include something that said that the fund would invest only in living wage accredited employers? Could there be clauses—I am thinking of some of the payback orders in renewable energy—about the number of apprenticeships that are created in an area as procurement and building go ahead?

Peter Morris: When we are procuring contracts for our local investments, we are always keen to have in place helpful measures on, for example, the number of apprentices. There was a significant number of apprentices for the One St Peter's Square contract, who worked on that site as well as on other sites. Such measures are fairly standard, and our house builder does some community activity as well. Generally speaking, the builders want to do such things. We deal with builders that are sizeable entities—for example, our house builder is Wates—because of the scale of the contracts that we let. At the same time, the people whom we appoint to do the work deliver it at a competitive price.

Dave Watson: Not surprisingly, I agree with that. Members have probably seen our work on the Procurement Reform (Scotland) Act 2014, and they will shortly see comments on the new procurement regulations. That consultation ends tomorrow. Along with a civil society coalition, we will publish our view on how we can use procurement in a more effective way. In our view, pension funds are certainly not exempt from that. I think that it is possible to do that within the constraints of fiduciary duty.

There are very clear business benefits from the living wage, for example, that we could quite happily include in the same way that has been proposed under the procurement regulations to achieve them. That is also true for wider environmental considerations, particularly as we are talking about public money as well as our members' money at the end of the day; it is a mixture of both. The broader Government goals on climate change, for example, which everyone signs up to, can be included. The test is whether pooling those things has any material detriment to the fund. I think that the answer to that question generally is no, but the way in which we word and do things just needs a little bit of teasing, guidance and help to avoid our getting into any difficulties.

Barry White: In major procurement, the procuring authority quite often stipulates those things rather than the provider of finance. For Dumfries and Galloway royal infirmary, there will be a community benefits clause as part of the contract, which will stipulate a lot of that. That is widespread in public procurement practice and is wholly accepted by the private sector.

If you are going to go more widely and say that pension funds as investors should invest in things only where such things can be guaranteed, because there are quite often small investors in a much bigger fund or smaller investors in equities on a worldwide basis, you might start to increase the monitoring costs or limit their opportunities to invest. I am not sure that people can currently put their hands on their hearts and say that they could control that as a very small shareholder in a very big fund or a very big company that might trade globally, for instance.

Procurers absolutely stipulate those things. On a local investment basis, I think that that would happen should the greater focus by pension funds on local investment happen—I think we would all like to see that—but we need to tread carefully in a wider portfolio.

Chad Dawtry: I would like to ensure that the committee understands that the regulations already require a statement of investment principles by each of the 11 funds. That is meant to take account of their environmental, social and governance responsibilities. It is entirely possible for the funds to set out their preference in investing, but there will always be a balance to ensure that an appropriate rate of return—however that is defined—for the investment comes back to the pension fund. That is at the heart of the matter.

To follow up on something that Mr Rowley said, it is helpful to remember that a pension scheme member—in the case of the local government scheme in particular, perhaps—will, of course, want to ensure that investment is going into the right areas. There is a triennial evaluation of the scheme. If it is not producing enough investment return, there will be a funding gap.

I have already referred to the fact that the funds are not 100 per cent funded now. That is not a massive concern, but it means that they have fewer assets on current values than the liabilities that they have. If too big a gap appears, employment contribution rates have to go up to try to pick up that gap. If there is not the right rate of return, an employee will, of course, want to ensure that money is going in the right place. On the other hand, they do not want to find a situation in which they are working for an employer that does not have enough money to spend on other services because it is spending all its money on investing in a pension fund.

Clare Adamson: I have a final question just for Mr Morris, I am afraid. Obviously, there is a long-term investment and the return for the houses that you currently have in place will happen over a long time. A short time ago, the Conservatives announced that they will extend the right to buy to social housing. If that came to pass, how would it affect your current business model?

Peter Morris: It would not affect us, because our properties are either for sale or are at market rent and are on long lease, in effect, to a landlord.

The help to buy scheme has been very helpful for us. It has made things easier. Half our purchasers have used help to buy. That means that they can buy a house with a 5 per cent deposit and there is a 20 per cent input with an equity loan from the Government.

11:00

Clare Adamson: At present, would the long-term landlord be a housing association?

Peter Morris: Yes, the tenant/landlord—as they would be from our perspective—would be a registered social landlord.

Cameron Buchanan (Lothian) (Con): Good morning. We have heard quite a lot about

Manchester, and I wonder whether it is typical of the English local authorities. Also, do you ever work together with other local authorities to invest at the same time?

Peter Morris: As you have probably spotted, the profile of collaboration between local authorities on the investment side is increasing. At one level the purpose of collaboration is to drive down investment costs and at another level it is to provide more expertise. Generally, the purpose is to help to produce higher net investment returns.

With regard to our activities, we are keen to work with other pension funds. We have one concrete example, which is an infrastructure partnership that we have just established with the London pensions fund authority. The partnership is investing in infrastructure and will target investments at Manchester and London, but there are no geographical barriers, so investment can be made outside those areas if opportunities exist. Again, the purpose of the partnership is to increase net returns to us.

We have good relations with the north-west funds and those along the M62 corridor. There are one or two examples in the north-west whereby, through pulling together, we are getting lower fund management fees in some specialist areas.

We are at the higher end of the range in terms of our enthusiasm for local investment, and we have been doing it for longer.

Cameron Buchanan: Do you find that working together with another pension fund actually works? Does Manchester lead in that respect? From what you are saying, it does.

Peter Morris: In our partnership with the LPFA, the agreement says that we will both provide a minimum number of staff—which is equal on both sides—to ensure that the joint venture works.

We have one or two examples of collaboration with other north-west funds whereby, through increasing our collective investment, we are getting lower fees as a consequence. Likewise, in our partnership with the London fund, that is one of the ways in which we will cut our costs and increase our net returns.

Willie Coffey: I want to return to the point that Mr Dawtry was leading us towards in speaking about whether schemes are fully funded. I think that he said that the 11 schemes that we have are not fully funded. I take it that they do not need to be fully funded in order to meet current obligations to pay pensions, for example.

I am interested in what has been happening in that respect, Mr Dawtry. Is there a trend over the past two years in which pension funds are becoming less fully funded? Can you tell us by what amount? Is that trend—driven by the need to top up funds, effectively—leading to an imperative to find new ways and new opportunities for investment?

If that is the case, what does the governance around all that look like? I am thinking about whether the people who invest in the funds can be assured that there will be some kind of pay-out to them when they require it at a future date.

Chad Dawtry: Just to be clear, that point was made in the context of balance, to ensure that the right level of return is coming in. There is not a situation in which the Scottish Government is concerned about the level of funding for the local government pension scheme in Scotland. The scheme is generally funded to a higher level than the counterpart scheme for England and Wales, but the fact remains that it is not 100 per cent funded.

That is an interesting question, because it depends on the specific day on which one assesses the funding level. The level is perhaps slightly down on where it was three years ago; I am not quite sure why, but the latest triennial valuations have only just been produced by the 11 funds. However, there is no concern—I would not want anybody to think that there is any concern—that pensions will be unable to be paid.

I think that that covers all your points.

Willie Coffey: Where is the imperative coming from for new investment in housing? It is great that you are doing that, but is it a necessity to get that sort of return on housing to ensure that the pension funds are being topped up, or do you just want to do it?

Peter Morris: From my perspective, now is the most difficult time—certainly in my working life—to be managing a pension fund. The reason for that is that we are, generally speaking, shrinking the number of employees in the fund, and the number of deferred and pensioner members is growing significantly.

In our fund, the value of benefits paid exceeds the amount of contributions by £100-odd million per year. We have investment income of £300 million, so it is not too big a deal from a cash-flow perspective, but it doesn’t half make things difficult.

The number of employers is growing rapidly in English funds, and again that makes it more complicated. We can superimpose on top of that the economic environment, given that nobody in this room could have imagined six years ago that we would have interest rates at 0.5 per cent and negative real returns. You can lend money to the German Government for 10 years, and you do not even get back what you gave at the outset. We are living in a weird, weird world. Liabilities for many funds are priced on the basis of what interest rates are, so the lower the interest rate, the higher the value of the liabilities. That is a key reason, because investment returns are higher than actuarial assumption, and that is driving the increasing deficits. It is a really tricky environment in which to be managing a pension fund.

Looking at the 10-year view for investment returns, most investments in bonds are going to deliver nil real returns. That is tough. One of the reasons that we make local investments is that we are enthusiastic about it, and we believe that we are capable of generating commercial returns. It will not make a massive contribution, but it will contribute positively to our funding position in the long term.

Dave Watson: I do not disagree with any of that. It is a challenging time for anybody who is involved with pensions—as I said, I have to deal with public sector and private sector schemes—but we should remember what we mean by the phrase "fully funded".

Essentially, as Chad Dawtry said, fully funded means that a fund's income matches its liabilities. It would have to pay that out only if everybody in the pension fund left tomorrow morning. Some of our members might fancy a bit of early retirement, but I am afraid that that is not going to happen. The reality of having to meet that immediate need is just not there—those are just the accounting tools that we have to use.

That does not mean that we do not have an issue. I would also point out that, in the previous valuation—there is one at the moment, and we are waiting to see the numbers that come out of it—Scottish local government pension funds were, on average, in the mid-90s in percentage terms. I have schemes in the private sector and the voluntary sector that would be at that level of funding only in their wildest dreams. There are private sector schemes at 50 or 60 per cent, and voluntary sector schemes in the same position, so 90-odd per cent is okay. Some of our funds were even overfunded at the previous valuation, at around 104 to 105 per cent. I am not saying that we do not have a challenge, as we certainly have, but we should be very careful that we do not start a panic based on the view that there is a problem in terms of the investment.

There is an issue of which funds must now be much more aware. In recent years, since the crash, 50,000 jobs—well, nearly 60,000—have gone from local government. A lot of the people in those posts—not all of them by any means, but many of them—have taken various forms of early retirement and that has a cash-flow implication.

When you are investing in and looking at pension funds, you have to keep an eye on where public sector finance is going. If it looks as if there will be further job losses, you have to have more in cash, or at least readily available funds rather than 25-year investments, for obvious reasons. It is a changing environment, but we should not be panicking about it.

Willie Coffey: That is very helpful—thank you.

The Convener: I thank you, gentlemen, for your submissions today. I suspend the meeting to allow for a change of witnesses.

11:09

Meeting suspended.

11:15

On resuming—

The Convener: I welcome our second panel of witnesses: Richard McIndoe, Strathclyde pension fund and head of pensions at Glasgow City Council; Steve Whyte, north-east Scotland pension fund and head of finance at Aberdeen City Council; and Bryan Smail, Falkirk pension fund and head of finance at Falkirk Council.

We have heard from other people about the restrictions that there are on local pension fund investment activity. What do you see as the major barriers to Scottish pension funds investing in local projects? We have also heard that some pension funds have ethical policies in place. Can you explain the position of your pension funds in terms of ethical policy?

Steven Whyte (Aberdeen City Council): One of the big barriers is the move into NPD or PFI-type deals for the financing of infrastructure and public sector projects over the last five to 10 years. That has seen a number of private sector elements come into the funding market and has opened the eyes of pension funds to such opportunities. The accounting regulations are a clear barrier to involvement in that marketplace and investment in infrastructure projects.

In Aberdeen, we looked at the potential to buy out the debt for our three Rs project when it was being sold by the financier about 18 months ago, but the restrictions on the accounting side were a barrier. We discussed that with the SFT and the Scottish Government to see whether there was a way around it, especially given that the debt was being sold below value. Such barriers are a restriction that we would like to address.

A number of schools for future projects are going forward. Within the agreement that we have with the hubco, we are able to purchase subordinate debt, but again only a small amount of public sector money can go into that. There are limits to what we can do using the pension fund as an investment vehicle for that. Pension funds have the potential to come forward and invest in such projects. There is a strong covenant behind those investments, because it is the local authority that would be funding the projects.

That is my initial assessment of the restrictions that we face.

The Convener: One of your housing guys in Aberdeen, Donald Urquhart, has a substantial and robust plan for the provision of mid-market rental housing. Would it be wise for the pension fund to get involved in that housing investment?

Steven Whyte: Absolutely. We are just starting to pull together the procurement around that to go to the marketplace. The pension fund is in discussion with officers about how it could put some investment into the houses—there will be around 1,000 of them—that will be built over the next two years. Again, the difficulty is trying to find a package that would allow that to work. Clearly, if we are talking about affordable housing, there will be some grant to make the financial model stack up. We need to get the right mix of affordable, mid-market and private housing.

Given the level of infrastructure projects that the council is producing at the moment, the pension fund is certainly starting to look at the potential for investing in those. Housing is just one of the elements. We currently have the city centre master plan for Aberdeen, which will emerge over the next five, 10 or 15 years. We also have the city deal from the Scottish Government and the UK Government, which has been supportive in principle and which will involve around £2.9 billion of investment in Aberdeen in the next 20 or 30 years. We are looking at the areas where the pension fund could step in and invest and get the level of return that it needs to justify such investment—it comes back to ensuring that the return to the pension fund is there.

The Convener: My next question is for Mr Smail. Falkirk is seen as one of the trailblazers in breaking down the barriers and using the pension fund for local investment. How have you gone about your business?

Bryan Smail (Falkirk Council): It flowed initially from our pensions committee taking an interest in exploring the potential to target infrastructure investment more locally. On social housing, we and the pensions committee spent quite a long time on a journey of exploration to get to the point at which we were comfortable that that was an appropriate option to pursue. The trail included a seminar that we hosted in Falkirk to which we invited a number of relevant stakeholders, such as legal firms, potential investors and registered social landlords. We used that to build up a picture of the potential, as we are obliged to do under the regulations. The fund also has a specialist adviser, who fed into the mix.

There followed a competitive tendering process during which we had offers from the market. In effect, we put a wide remit to the market to see what was out there. We were flexible, in that we allowed the market to come forward with innovation and initiatives. Last year, at the end of the journey, the pensions committee took a view, and we selected a tender, which we are actively pursuing at the moment with actual investment in housing. In fact, yesterday, the relevant council committee affirmed from the council's side—you need to bear in mind that the pensions side is separate—a proposal that will harness part of the £15 million that has been allocated to social housing for actual investment in the fund's area. That involves about 90 houses, so we are moving forward, and things will start to happen on the ground soon.

The Convener: Mr McIndoe, will you give us the Strathclyde perspective on the barriers?

Richard McIndoe (Glasgow City Council): Our perspective is that there are no absolute barriers or impediments to investment in infrastructure, including local infrastructure or Scottish infrastructure. Strathclyde has invested £275 million in infrastructure to date. We started very recently, because infrastructure was not really a recognised asset class or investment strategy for institutional pension funds until the past few years.

Much of our investment has been in Scotland. We have used a mechanism that we created internally, which we call our new opportunities portfolio. Our existing investment structure is, I guess, a fairly commonplace structure among UK pension funds. It involves appointing external investment managers to run what are usually fairly large portfolios of mostly listed and, to a large extent, overseas investments—we are a global investor. We recognised that that did not give us much of a facility to invest locally so, in 2009, we created that facility, which is the new opportunities portfolio. It is not a local investment portfolio, but it has a very wide remit to invest in all sorts of things. From the outset it has had a preference for what we call impact investments, which are investments with some positive impact, either in social, governance and environmental terms, or in local investments.

To date, the majority of investments through the new opportunities portfolio have had some form of local element. Its initial focus was on small and medium-sized enterprises in Scotland, and we made a couple of investments in that area. We have also invested through the Scottish loan fund, which is a creation of the Scottish Government and in which we were a founder investor, and through Panoramic Growth Equity, which has a UK-wide investment remit but which located in Glasgow after we agreed to co-invest with it. There are a couple of other vehicles, too.

From the outset, we were more familiar with company investment: we are largely an equity investor; in fact, we are a very well-established private equity investor. Quite early in the journey, we recognised that there might be opportunities in infrastructure and housing. In 2012, we wrote into the portfolio's remit that we would focus on infrastructure, housing and economic development.

The deals that we have done to date include a couple of housing-related investments, most notably the City Legacy project, which built the athletes village for the Commonwealth games in Glasgow last year. Subsequent to the games, the units were retrofitted and have become 700 social or mid-market housing units and various other facilities. We did not provide the major part of the funding package for that, although we played a significant role by providing the cashflow funding, which was the last piece in the funding package jigsaw.

The Convener: We are well aware of the athletes village, which many members have visited. Has the Strathclyde fund been involved in any other housing investments?

Richard McIndoe: We have made a couple of commitments recently. One was to a UK-wide supported living residential development, and the other was to a specific residential project in East Lothian, for which we are providing the cashflow funding as part of a larger funding package.

We are looking at various other housing projects that may come to fruition shortly, but so far we have not identified one where all the pieces fit together.

The Convener: Thank you. My other question was whether the witnesses can indicate what their pension funds do on ethical investment.

Steven Whyte: We look at wider global markets. The council's view and the pension fund's view is that we need to look at returns. To be honest, the pension fund invests in tobacco companies.

The Convener: And arms.

Steven Whyte: I believe so, yes. In that respect, the pension fund is quite clearly looking to get returns from high-yield investments and companies.

The Convener: So what we are really saying is that the north-east Scotland pension fund does not have an ethical investment policy.

Steven Whyte: It has an ethical policy, in terms of the wider world and not investing in war zones and things like that—

The Convener: Just the arms that are going into the war zones.

Steven Whyte: I would need to look at exactly which companies we invest in.

The Convener: It would be very interesting to look at the ethical statement that the north-east Scotland pension fund says that it adheres to.

Bryan Smail: In common with all funds—you heard Chad Dawtry talk about this earlier—we are required to have a statement of investment principles, which is kept under review. I suppose that the essential part of the ethical stance is proactive engagement with companies, where there are issues. That is done on our behalf—

The Convener: Maybe I will just cut to the chase, as I did with Mr Whyte. Do you invest in tobacco companies?

Bryan Smail: Yes, and also in alcohol companies, companies that sell fizzy drinks and so on.

The Convener: And arms?

Bryan Smail: Yes. My point is that you have to ask where you would draw the line. A range of products do not have benign properties attributed to them. A pension fund would have some difficulty deciding where to draw the line.

11:30

The Convener: Again, it would be interesting for us to get your statement of intent.

Mr McIndoe, what is the Strathclyde situation?

Richard McIndoe: Similarly, we do not exclude any particular sector or category of company from our investment policy. That is common to almost every UK pension fund that I know of: they do not exclude investments. There are various other ways to achieve ethical, environmental, social and governance aims—

The Convener: But not through pension funds.

Richard McIndoe: Not through disinvestment in companies.

The Convener: Thank you. Again, it would be helpful if we could get a statement of your investment principles.

Alex Rowley: I think that the work that is being done by Strathclyde pension fund is extremely impressive. Although I have never visited the Commonwealth village, I saw a story about one of the first tenants going into their housing. It was a great story, and it was great to see. It is that type of investment that I am interested in.

Have you had to increase the expertise within the management of the fund by buying it in? You seem to be ahead of the game in comparison with a lot of the other pension funds in Scotland. Do pension fund managers come together to share information?

Richard McIndoe: The answer to both questions is yes. We had to increase our expertise because our work on infrastructure and the new opportunities portfolio was a departure from our previous investment strategy. We managed the early investments through our existing resource, but we quickly realised that we would need more resource. To date, we have hired only one individual to specifically focus on the portfolio, and we have bought some external expertise in the market.

The portfolio continues to expand—we have just increased its capacity to 5 per cent of the total fund, and the resource will need to expand alongside that.

What was your second question?

Alex Rowley: It was about sharing information. Perhaps I can expand on it.

When I raise questions with finance departments, such as the one at Fife Council, they say that, if we want big investments in, say, housing, we need a number of funds to come together. Is getting the funds to work together the way to try to move things forward, or are some funds too small to take on the type of thing that is undertaken by Strathclyde, which I assume is much bigger than the other funds?

Richard McIndoe: Strathclyde is by some distance the largest of the 11 funds in Scotland.

The approach that you suggest is potentially the way to move things forward. A fairly good example is the pensions infrastructure platform, which we are a founder investor in. That brought together a number of the leading pension funds in the UK. It did not bring together all the local authority funds, but the West Midlands pension fund is an investor in it, too. It was billed as an investment vehicle by pension funds, for pension funds. It is making very good progress and has agreed its first two investment tranches. We have committed £70 million to it contractually and £100 million in principle.

Progress has been slow. There are numerous practical issues around bringing together a group of investors, even if they are essentially like minded, as is the case with the funds that we are talking about. When you come down to the detail of what you want to do—the details of the strategy, the funds' investment rules and the governance procedures to get things agreed—you find that these things take time.

That sort of model could apply in Scotland. The Scottish loan fund, which was a vehicle that was created for pensions funds and other institutions to invest in Scottish small and medium-sized enterprises, is such a fund.

We frequently speak among ourselves, but that has not led to any collective investment, although there are some shared investments—Aberdeen also invests in the SLF, for example. However, there is certainly potential there.

The Convener: Why has that potential not been realised up to this point?

Richard McIndoe: We have lots of investment potential and are focusing on a bunch of different things. Moreover, other people in the market are trying to create infrastructure and housing deals and they might be more obvious facilitators. Such projects tend to need a facilitator who can bring funds together and co-ordinate things.

The Convener: So why not put in place such a facilitator for Strathclyde, the north-east or Falkirk?

Richard McIndoe: That would not be impossible, but it is not part of what we have done to date. We usually invest in vehicles that other people have created; the creation of a vehicle requires a different skill set.

The Convener: Why do you think that it has not happened thus far, Mr Whyte?

Steven Whyte: I go back to Mr McIndoe's point that pension funds look for a vehicle to invest in. The creation of those vehicles probably requires collaboration from the council, and I suppose that that collaborative working has been gaining impetus over the past couple of years, with local authorities now working much more closely with one another. For example, the city deal in the north-east is a collaboration between Aberdeenshire Council and Aberdeen City Council.

The collaboration is starting to happen, and infrastructure projects are going to start to come to fruition. By definition, the vehicles have to be formulated to allow that to be delivered, and their formulation gives the pension funds the opportunity to do the financial due diligence to find out whether the vehicle provides a return that fits in with their investment strategy and would allow them to make the investment. That is the stage that we have reached in the process, but there has definitely been greater movement towards such collaboration across Scotland.

Bryan Smail: A couple of years ago, the funds explored with the Scottish Government's financial innovation unit whether a vehicle could be pulled together. At the time, there was perhaps some scepticism across the funds about aligning their objectives with social housing. As you have heard from various speakers, things have matured and moved forward, and the market is probably better placed for such a vehicle to come on stream.

We have provided £30 million as an initial investment in a housing fund for Scotland; I do not think that this is a rigid figure but, according to the fund manager, £150 million could be channelled through that source. That vehicle is already in place—the market itself is emerging and developing.

The Convener: That was useful.

Alex Rowley: I will be sending the stuff about Strathclyde to the director of finance at Fife Council, Mr Brian Livingston, and saying to him that those are the kinds of investments that we want.

Previous witnesses talked about a zero return on bonds, and someone highlighted the example of making investments in Germany and not getting a return. Given the current financial climate not just in this country but across Europe, is this a good time to be making such investments? These days, given the financial instability that exists in the world, would not a rolling programme of investment in council housing, in which you were guaranteed a rate of return, be more secure?

Who comes up with and examines possible investments? Who looks at whether public infrastructure in Scotland would be a sound investment, and who ultimately makes such recommendations? Do you have fund managers who do that?

Bryan Smail: If I jump back to the example that I gave of Falkirk's social housing, there was a period when our committee took the time to get a proper handle on and an understanding of the potentials of the market. That was done with a range of inputs from various sources including the fund's advisers. Having undertaken that journey and that research and gained that understanding, the committee reached a view that an investment in social housing of perhaps 2 per cent of the fund represented a proper and attractive option for us.

As has been alluded to, social housing—indeed, housing in general—have the attraction of marrying very well with pension fund liabilities, given their long-term nature and frequently inflation-adjusted returns. Those factors and attributes fed into the decision-making process on the proper level of investment.

I can perhaps categorise the situation as a win-win. Given all the comments that were made earlier about the fiduciary aspect and the requirement to operate within a framework of regulations and case law, each fund has to take responsibility because we stand alone as legal entities, albeit that we operate in a broader framework. Each fund has to take a view as to how it will navigate its way through the issues that pervade investment decisions of this ilk. Our fund concluded, as the Manchester fund did, that the return from housing was consistent with overall fund objectives, and the other win was the capacity to enhance local infrastructure. That is it, in a nutshell.

Steven Whyte: Over the past three or four years there has probably been much greater understanding that there is a housing shortage in Scotland. In the north-east, the level of private sector development has continued quite rapidly, but there are a very different dynamic and economic conditions in Aberdeen, which have led to a real housing shortage of mid-market rents in Aberdeen. The economic conditions in Aberdeen are such that the mid-market rents that we would traditionally expect are considerably higher than they are elsewhere in the country, which means that it is difficult for the council to attract key workers including teachers and social workers, it is difficult for the health service to attract nurses, and it is difficult for the police force to attract police officers. That has resulted in almost a market failure, so the public sector is being required to step in and correct that. That is creating a vehicle that will result in new house building in that market, which by definition offers funders opportunities to come in on the back of that. We are seeing a new kind of market emerging.

In the north-east, we have not yet seen heavy investment from pension funds because that market condition is only starting to materialise and pinch on the local economy and the growth of the city. As I said, we are seeing emerging demand, and the council is stepping in to start thinking about how it is going to meet that demand with 1,000 houses over the next two years. That will offer opportunities for the likes of the north-east Scotland pension fund to step in and invest and get a return.

Again, however, that needs to be measured against other returns that we might get. We heard earlier about getting a nil return if we were to invest in Germany, but we can invest elsewhere and still get a positive return. We cannot just look at one investment vehicle and say that it is the comparator. The whole point of the portfolio is for it to be diversified so that we do not expose ourselves to just one particularly strong market area, and so that if there is a downturn in a particular area, we can still generate sufficient returns to meet our future liabilities.

11:45

The Convener: The question that Mr Rowley posed about fund managers remains unanswered. Are the fund managers guiding investment in the main, and who are those people?

Steven Whyte: We invest with fund managers in UK-wide infrastructure. The figure is about £300 million for the north-east Scotland pension fund, but that is across the UK and fund managers are generally looking to invest in more investment-type properties.

Initially, we would assess housing developments internally, rather than through potential fund managers. We would need to understand whether we have in-house expertise or need to bring in additional expertise to facilitate that. It is an emerging area, so we have to watch and decide how we would like to move forward.

We would not want to start engaging immediately with fund managers specifically on social housing projects, because clearly they would charge fees. We need to understand our internal capacity and capability before we consider using fund managers for social housing projects.

The Convener: In current discussions, are the fund managers that you currently have in place trying to put off your pension fund from investing in social housing?

Steven Whyte: No.

The Convener: Grand.

Richard McIndoe: In terms of the decision-making process, for the new opportunities portfolio we have created a clear and robust governance process in which officers will initially source investments through the market, through contacts. We filter those down to the ones that are most ready to take forward. They go to a board—effectively, a subcommittee of the main investment committee—that includes the director of finance. Any decision is ultimately down to the investment committee.

Throughout that process there may be reliance on a fund manager, in which case—officers will do extensive diligence on them—they will have to present to the various boards and, potentially, to the committee, before a decision is made.

Are our existing fund managers trying to put us off investment? No—one or two are actively trying to facilitate investment in housing. The market housing opportunity will come. As I said earlier, we have not yet found anything that we can invest in at scale. It will come.

The social housing opportunity may be a little more difficult because the rate of return remains a bit of an issue. Where the covenant is very good, with strong public sector rents and a clear income stream, that is very helpful. Historically, registered social landlords have been able to borrow at very low rates. The interest rate remains very low.

As Peter Morris said earlier, the funding model for local government is based on a 3 per cent real return. Within our local investment model, that translates to an absolute floor—a minimum hurdle—of 5 per cent per annum for any investment. We need a return above that, depending on the idiosyncratic risk of any individual investment. Social housing is still struggling to make that hurdle. However, affordable mid-market housing will make it more easily, so that is probably coming.

Cameron Buchanan: The Strathclyde pension fund submission, under "Practicalities", says:

> "approving funding should not be underestimated. Each can represent a significant impediment. For a project to succeed it needs strong and committed leadership to manage each of these stages."

Do you provide strong and committed leadership? You mentioned the Commonwealth games, in which you were a significant investor. Were you leading that and, if so, do you lead any of the investments?

Richard McIndoe: The Strathclyde pension fund was not leading the Commonwealth games project—the council played a much bigger role. It would be rare for the pension fund to lead an investment project; the creation of an investment vehicle requires a different skill set. Most investment managers find the creation of the vehicle and the raising and co-ordination of funds to be something of a time-consuming distraction from the process of investing. We are an investor—creation and co-ordination of investment vehicles is not really our business, so typically we do not lead investments.

John Wilson: The Strathclyde pension fund submission says:

> "In practice however, pension funds have often not found infrastructure investment easy to achieve. Reasons cited are a lack of in-house expertise, high external manager fees, risk inherent in greenfield infrastructure investment"

and so on. Why have the pension funds not brought expertise in-house to deal with issues that you have identified? If high management fees are putting you off investing in particular areas, has there not been an opportunity lost to invest in in-house expertise, so that the pension fund could take things forward without having to approach external managers?

Richard McIndoe: We are taking that opportunity and we are trying to take that forward. The particular things that John Wilson mentioned from my paper are in a quotation from our initial investment proposal for participation in the pensions infrastructure platform. The pensions infrastructure platform was created partly to overcome those barriers.

We are a founder investor, and there are further tranches of investment to come through that platform. It has successfully overcome those hurdles, and the collective of pension funds has recently appointed a chief executive who has great expertise in the infrastructure market. The first tranche of investment was through a fund, but the collective was able to negotiate a fee for the vehicle that was some way below what I think would have been the market level. That is happening, at least in that particular instance, and I think that there will be more of that.

John Wilson: You mentioned external manager fees. I ask the three panel members: what is the average cost of administering the pension schemes that are administered by local authorities in terms of the turnover of the pension fund. Some fees are borne by the administration of the pension fund. How does that compare with wholly handing over the pension fund to an external manager?

Richard McIndoe: To put a number on it, I say that our investment management cost is a little below 0.2 per cent of investments under management. That is all external cost. For individual investments, it varies from a very small percentage—less than 0.1 per cent for passive listed equities—to 1 per cent or more for more complex investments. That would include infrastructure funds, which are complex investments that typically need a lot of management. The typical market fee for an infrastructure fund would be at least 1 per cent, I think. There is usually a performance element attached to that.

The Convener: What is 0.2 per cent in cash terms? Although 0.2 per cent does not sound very much, I am sure that 0.2 per cent of the Strathclyde pension fund adds up to a huge amount of money.

Richard McIndoe: The amount is £18 million per annum in our 2013-14 accounts. The figure for 2014-15 that will be disclosed in this year's accounts will be significantly higher, because the disclosure rules have changed. The figures will include not only what we pay in investment management fees, but various other costs that underlie the investments, including transaction costs. The amount includes all the management fees for every layer, where we invest in funds or a fund of funds.

The Convener: Is there any indication of what that number will be?

Richard McIndoe: No. We have another six weeks to put the number together.

Steven Whyte: The cost of administering the fund internally is probably about £1 million, which covers administration of the payment of benefits and the investment side.

The fee structures for the individual fund managers will vary depending on the type of investments that we are asking them to make on our behalf. Again, I would struggle to provide the number off the top of my head, but it would be several million pounds. Because of the new disclosure rules, we will not—like Strathclyde pension fund—have that number until we complete the 2014-15 accounts. I will be happy to supply that information to the committee when we get to that point.

The Convener: That would be very useful.

Bryan Smail: The framework that Mr McIndoe outlined for percentage rates would be common across all funds, and the cash equivalent would be proportionate to the funds.

It might be helpful for the committee to know that a strand of our local infrastructure investment in addition to social housing is a partnership arrangement with the Lothian pension fund. In our evaluation of that arrangement, we concluded that by using that channel and its in-house capacity and expertise—it is a much larger fund than we are—our management costs were about a third of what we would have expected to pay had we used an external manager. That is a clear example of using in-house potential—albeit that it was not our in-house potential—to save on management costs.

The Convener: It would be very interesting for us to see those numbers, too, so if you could pass them to the clerks, I would be grateful.

John Wilson: I will follow on from Mr Smail's point about the Lothian pension fund and the Falkirk Council pension fund working relationship, and the utilisation of expertise from different pension funds. What opportunities are there for the 11 pension funds to work Scotland-wide in that collaborative fashion on their investment programmes?

Bryan Smail: There may well be such potential for infrastructure investment, in a parallel manner to what we touched on earlier with respect to social housing. At the moment, there is a process of evolution. For example, the Falkirk Council pension fund engagement with the Lothian pension fund is, in itself—albeit on a relatively small scale—an innovation, and it demonstrates willingness to explore new avenues. Perhaps over time, on the back of discussions such as this, such things may well boost more thorough exploration of that potential. Work in progress might be a fair way to categorise it.

Steven Whyte: Representatives of the pension funds meet regularly. As we touched on earlier, collaboration in the overall local government agenda is on the increase. There certainly needs to be more detailed exploration of where cross-pension-fund working can take place.

At director-of-finance level, that agenda is starting to shape up across Scotland. I am head of finance for Aberdeen City Council, but I am also head of finance for Shetland Islands Council. Such collaboration is starting to materialise across Scotland. We are at an early stage of that in the pension funds. A lot of us have mandates that we are tied into, so we need to start understanding where the potential is for sharing expertise. I concede that that is probably in its infancy.

Richard McIndoe: I do not have much to add. There has been a lot of collaboration historically, but it has largely taken the form of sharing ideas, experience and information. There are a couple of other examples across the UK. The administration system that most funds have used is not jointly procured but is jointly commissioned from each provider right across the UK.

On responsible investment, our fund has just joined the local authority pension fund forum. The majority of local government funds are members and the forum is quite a significant voice in lobbying companies in the UK and further afield about their standards of responsibility. It is the spirit of the day to extend that to collaborative investment, but there has not been much of that to date. Those partnerships are just starting to be formed.

12:00

John Wilson: It is interesting that Mr McIndoe mentioned responsible investments, given the earlier discussion about ethical investments. As the convener said, it would be interesting to see the paperwork on the pension funds' ethical investment strategies.

In an earlier response, it was said that part of the investment strategy was mainline investment because no alternative investment vehicles had been established. Some of the pension funds have been around for three decades. Has there been any discussion of joint work by the pension funds on investment vehicles that are more socially responsible?

Richard McIndoe: Historically, there has been only infrequent discussion of collective investing. There is no shortage of investment routes or vehicles for pension funds and we have all pursued our own strategies. Only more recently has the discussion of collective investment by local authority funds come to the fore.

That could also involve a responsible investment vehicle—it depends on the definition of responsible investment. Most of the procurement of investment that we do will have certain governance criteria. We are an active promoter of the living wage—a very vocal proponent of it, in fact—so any vehicle that we created would embed such measures. However, I do not know whether it would be directed towards a particular type of ethical investment. I do not think that there are any plans to construct such a thing.

The Convener: I will play devil's advocate, which I tend to do at some point in the committee's meetings. You gentlemen are here today in your roles as pension fund managers, but all three of you are also heads of finance with your authorities—in Mr Whyte's case, it is two authorities. We have discussed investment vehicles. If you were wearing the hats that you are not wearing today, your councils could readily create those vehicles for your funds to invest in.

We have heard about discussions being in the early stages, but surely councils have already discussed some of the issues. That goes back to Mr Rowley's earlier point about political will. Does the political will to create responsible investment vehicles exist? Is it being ignored? Although you wear your separate hats at various points, at some point there will have to be an intertwining to get things moving in that regard.

Richard McIndoe: I should clarify that I wear only one hat. I am responsible for the pension fund; I am not a director of finance.

The Convener: I am sorry—I beg your pardon.

Richard McIndoe: On whether the political will exists, our investment decisions are made by our politicians and, as I said, we have invested £275 million and have capacity to invest £775 million in the new opportunities portfolio as it stands. There is certainly a willingness.

Steven Whyte: We are at quite an advanced stage in the procurement of additional housing in Aberdeen and, in the next three or four months, we will get to a position in which a proposition can be made to the pensions committee. Once we have made a proposition to it, we will have a better understanding of its view on the investment. Clearly, it is a committee decision but, from what I can see, the political will exists to move forward as quickly as possible. We are under instruction to have the 1,000 houses built by 2017, so we need to get the vehicle and the investment in place over the next few months.

Bryan Smail: It is important to bear in mind that the pension fund is very much a separate and discrete legal entity with its own specific responsibilities. It is a case of wearing two hats, and one must be wary of and sensitive to potential conflicts of interest. A practical example of that is our pension committee's decision to invest locally in Falkirk housing. In making such intra-council decisions, one must be careful that one separates advice pertaining to the pension fund and its objectives from the council's imperatives relating to its responsibility for its own housing stock. It is an important area to have regard to and to be aware of.

Willie Coffey: We are having a very interesting discussion. Let us return to the issue of transparency on the involvement and participation of local members in the decision making that Mr McIndoe referred to. In my experience, it was not particularly clear which companies the pension funds were being invested in and to what purpose. I do not recall that level of detail ever being shared with elected members. I find it difficult to believe that, these days, local councillors or whoever would be comfortable with proposals to invest funds in arms or tobacco companies. Can the panel give us any examples of their various pension funds having been prevented from investing in what folk might consider to be unethical sources? Is that investment taking place behind the scenes and under the radar, through overall investment strategies?

With the new regime that is coming in and the transparency that we hope it will bring, will such matters be much more in the public gaze? Will the public be able to see where the investments are being made and perhaps ask for disinvestment to take place? Over the years, it has never been clear to me where the investments have been made, and I would be interested in your views on that.

The Convener: I know that certain councillors are already unhappy and have made their views known in various places.

Steven Whyte: We are quite transparent with councillors about investment decisions. We set mandates for fund managers and they meet the pensions committee regularly to discuss the investments that they have sold or taken on over the period within the agreed mandate. The process is probably as transparent as it can be. Those discussions with the fund managers may be held as exempt because of the commercially sensitive information that they involve about how the fund managers are investing and what their investment strategies are.

The Convener: How often are councillors who make those decisions and meet the fund managers told that, if disinvestment took place in certain areas, they would be failing in their fiduciary duty?

Steven Whyte: Sorry—could you ask that question again, please?

The Convener: The councillors who meet fund managers may have opinions about disinvestment in certain areas. Are they told that they would be failing in their fiduciary duty if they removed investment from, say, arms or tobacco companies? How often does that happen?

Steven Whyte: Members meet the fund managers regularly, and it would be up to an individual member of the committee to make such a comment to a fund manager.

The Convener: One of the greatest fears that any councillor could have is of a finance officer saying to them, "If you do that, you'll be failing in your fiduciary duty." If a councillor who has talked about disinvestment is told by an adviser to the committee—it may be a council officer such as the fund manager—that they would be failing in their fiduciary duty, is it likely that they would still try to secure that disinvestment?

Steven Whyte: That would be a decision for the individual committee member to make. My role would be to provide professional advice on any decision that the committee was trying to move towards. If the member wanted us to pull out of a particular investment and invest elsewhere, we would need to weigh up the fund investment portfolio as a whole, not just focus on a particular element of it. To some extent, it would depend on the disinvestment that the committee member was proposing and how we would articulate that back into the overall investment strategy.

The investment strategy is reviewed annually—we are about to reset our investment strategy moving forward. Now that we have had our triennial valuation, we have an understanding of the funding level within the pension fund, and that drives the investment strategy that we will sit with.

Bryan Smail: As has been outlined, the governance arrangements are changing. At the moment, our pension committee consists of six councillors, one representative of the trade unions, one representative of other employers and one pensioners representative. There are a range of stakeholders around the table.

From time to time, there may be a particular flurry in the media about a certain aspect of investment, such as investment in tobacco or armaments, and discussions take place. They can also take place as part of a strategic review. We are due a review—that will probably be the case for most funds—on the back of the triennial valuation that has just been completed. There are also other triggers, so the issue is kept very much in the arena.

To cut to the chase, there is a significant issue that needs to be addressed around fiduciary duty. Given that the members of a pension committee are trustees and their primary objective is to make returns for the fund to enable pensioners to be paid, if a decision was made to disinvest significantly in armaments, tobacco or any of the other raft of areas that can potentially be in the frame but are held to be not benign products or services, the committee would have to be very careful—because of its fiduciary duty—to ensure that it could make that decision without detriment to the returns of the fund. In simple terms, if the committee decided to disinvest in any of those areas and could find an alternative investment that gave the same or better returns, that would allow a route to be navigated through. Conversely, if the advice was that such a decision would risk diminishing the returns that could be made from the investment, I think that the trustees would be in an invidious position.

We all appreciate that these are sensitive and important areas and that stakeholders have widely and strongly held views on such issues, but the decisions need to be anchored in the primary fiduciary responsibilities of the trustees of the fund under the current regulations and case law.

The Convener: In many cases, folk may have very strongly held views but the advice that they are given is that they cannot disinvest, because to do so would be to fail in their fiduciary duty.

Bryan Smail: As my colleague said, it would be for the individual trustees to make the decision. Our role would be to advise. We are not the trustees; the trustees are the ones who make the decisions.

The Convener: I understand that, Mr Smail.

Richard McIndoe: As a fund, we are transparent. All the business of the fund is carried out in public and all our committee papers are publicly available. They include a huge amount of detail on our investment strategy, our investment structure and our investment performance. That is where we try to focus, as that is largely what investment is about—for us, it is about strategy and structure.

The last time I looked, we had about 2,600 individual lines of investment and perhaps as many as 80 to 100 fund investments, with each of those funds making numerous underlying investments. It is a very long list that is available on request. We periodically publish a full investment list, but not very often. From our perspective, it is about the strategy that we are pursuing rather than the individual investment lines.

12:15

As far as fiduciary duty is concerned, historically, various funds, including ours, have at some point sought counsel's opinion on what "fiduciary" means in respect of investment responsibilities for a pension fund. That has tended to support the idea that disinvestment on the basis of ethical considerations would be a breach of fiduciary duty. That has tended to be the advice to committees on the basis of counsel's opinion, and I think that, to date, that is still the case.

That may be changing, because in light of a Law Society of Scotland review last year, there has been some reinterpretation of fiduciary duty—Dave Watson alluded to that in the earlier evidence session—but the reinterpretation has not been tested yet. However, in the past few weeks Glasgow City Council agreed a motion to commission a report on the possibility of disinvesting from all fossil fuels. I am in the process of working out how to get such a report and who can provide it. It is likely to include counsel's opinion in light of the recent reinterpretation, so we will be revisiting that in the course of this year.

Willie Coffey: I thank our three colleagues for clarifying that point. Do you anticipate a change to regulations to allow pension funds to include the ethical element correctly and properly in a way that might ultimately overcome the concern about the fiduciary duty of the members who serve on pension fund committees? Is that scenario coming?

Bryan Smail: I find that difficult to imagine, although I am clearly not in a position to predict the future and I will not make such decisions. However, I would find it difficult to believe that there would be a market change in the current scenario. I think that my view is consistent with a lot of what we have heard in the meeting, in that there is more of an evolution in stages.

As Mr McIndoe touched on, one can perhaps see that over a couple of decades. Earlier, Dave Watson referred to the famous Scargill case. There has been a move from a more trenchant view on the issue to more contemporary views. I think that the position becomes more nuanced, but I do not think that it fundamentally changes. I do not think that regulations of themselves will fundamentally change the fiduciary duty and the responsibility that individual trustees have, after listening to their advisers, to make a call on it. I see regulations as a component or a subset in the equation, and relaxation of those may more readily accommodate the mechanisms by which social and infrastructure investment may be taken forward more fruitfully or readily.

Steven Whyte: Obviously, we can put in place legislation and give guidance on that. Fundamentally, though, if anyone was going to look to disinvest in specific elements, they would need to understand what the impact of that would be. Obviously, a lot of the areas that we invest in are high-returning or high-yielding investments, so we would need to understand what precluding them from an investment strategy would mean for medium-term and longer-term financial planning. Clearly, the onus would come back to the employers through enhanced contribution rates, and during a time of difficult financial settlement that would place greater burdens back on to the local authority and would impact on front-line services.

As the convener said, when we have to wear two hats, as we try to bring the two together, there are clear impacts from restricting the types of investments that the funds could make. From that perspective, there is a weighing up of the impacts. Clearly, wearing my director of finance hat, I would come back to the Scottish Government and say that, if it is going to restrict the level of investments that I can make in a particular area, it will need to increase my funding settlement so that I can afford to pay a higher contribution rate back into the fund.

It is about trying to get the correct balance. Although I understand the ethical arguments, fundamentally, some of our strong performers and our strong-yielding investments are in the very areas that, potentially, we might want to preclude.

Richard McIndoe: I do not have much to add. I struggle to see how the regulations would change to allow us to accept a lower investment return by taking other considerations into account. It seems a slight distraction from the focus of the fund on paying pensions. Clearly, allowing us to accept a lower return would have knock-on consequences, primarily on the employer contribution rate, which is the balancing element in the funding equation.

The Convener: You have opened a can of worms, Mr Coffey.

Willie Coffey: Are those who make pension contributions, such as me, ever consulted or asked about whether they agree with the investments that are made on their behalf? Surely the pension funds belong to the people who make the contributions and not the fund managers.

The Convener: Please give a yes or no answer if possible, gentlemen.

Willie Coffey: Also, if the people who make the contributions to the pension funds ask that you do not invest in something, is that a way to overcome your difficulty? Surely that is enough.

Bryan Smail: Yes, in so far as employees are represented on the fund and they will be more represented under the new governance arrangements.

Steven Whyte: Mr Smail has answered the question.

Richard McIndoe: I agree.

The Convener: Mr Wilson can ask a very brief question.

John Wilson: The Scargill case has been mentioned, in which Arthur Scargill challenged a fund manager. Mr McIndoe gave the example of Glasgow City Council taking a decision to disinvest in fossil fuel industries. When a local authority takes a decision, is it the fund managers who make the final decision on whether to endorse and implement a council policy? As the convener said, councils could have a policy to disinvest from the armaments industry, but the fund managers could then override that decision.

The Convener: Very briefly, Mr McIndoe.

Richard McIndoe: The council has decided to commission a report to investigate disinvestment from fossil fuels. The council agreed that the report will go to the Strathclyde pension fund committee, so it will be a pension fund decision whether to implement that policy.

The Convener: So it will be not the fund managers but the actual fund panel members who make that decision.

Richard McIndoe: Indeed.

The Convener: Just for clarification, how many councillors are on the panel?

Richard McIndoe: Eight.

The Convener: How many others are on it?

Richard McIndoe: There are just eight—the committee is made up of the councillors.

Clare Adamson: I just want a bit of clarification on the area of questioning that the convener pursued about political will in the council and how that conflicts with pension fund decisions. I think that Mr McIndoe said that it is the politicians who make the decision, but Mr Smail went on to talk about his two hats and the pension fund being a separate legal entity. When councillors make such decisions, do they leave their political hats at the door and act only in the interests of the pension fund?

Bryan Smail: Strictly speaking, as regards the fiduciary responsibilities of those councillors, we draw heavily on actual trustee law—it does not directly apply but it heavily colours interpretations—so they should act in the best interests of the members of the fund. However, we live in the real world and it is difficult to imagine, as human beings, that one can be completely divorced from one's political hat. That is not necessarily wrong. It is a difficult balancing act.

Steven Whyte: My understanding is that the councillors should not wear a political hat while they are making those decisions. I cannot answer for them individually as to whether they do that, but that is my understanding of what they should do.

Richard McIndoe: That is also my understanding of what they should do and that has been my experience of what they do. It has probably become more difficult to do, because pensions have become rather more politicised than they were in the past. As I think Mr Smail alluded to, it is more difficult to set aside politics. However, there is a large degree of separation between the pension fund and the rest of the council.

The Convener: Thank you very much for your evidence, gentlemen.

12:25

Meeting continued in private until 12:33.

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