



LOCAL PENSION COMMITTEE – 27TH MAY 2016

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

**INVESTMENT POOLING WITHIN THE LOCAL GOVERNMENT PENSION SCHEME –
PROGRESS TO DATE**

Purpose of the Report

1. To inform the Committee of the latest position in respect of the on-going activity in respect of the requirement for the Local Government Pension Scheme (LGPS) to be formed into a number of investment pools, with the first investment in the pools being made by 1st April 2018.

Background

2. The Summer Budget of July 2015 contained the following announcement:

“The government will work with the Local Government Pension Scheme administering authorities to ensure that they pool investments to significantly reduce costs, while maintaining overall investment performance. The government will invite local authorities to come forward with their own proposals to meet common criteria for delivering savings. A consultation to be published later this year will set out those detailed criteria as well as backstop legislation which will ensure that those administering authorities that do not come forward with sufficiently ambitious proposals are required to pool investments.”
3. In May 2014, and following analysis of the responses received from the Call for Evidence, a further round of consultation was launched. This consultation ruled out forced Fund mergers in the near term and focused on the possibility of asset pooling (possibly via the formation of a small number of Common Investment Vehicles) and the increased use of passive management, both of which were thought to offer potentially significant savings in investment management fees across the LGPS.
4. In late-November 2015 the Department of Communities and Local Government (DCLG) issued a document entitled ‘Local Government Pension Scheme: Investment Reform Criteria and Guidance’. This document had been widely anticipated and did not contain any surprises to those Funds that had been close to the discussions that had been taking place between the interested parties.
5. The November document was the first time that the criteria against which the various options would be judged had been formally laid out. The four key criteria were:

- A. Asset pools that achieve the benefits of scale – minimum size £25bn;
- B. Strong governance and decision making – the governance structure should provide strong governance at both a local Fund level, and also at a pool level;
- C. Reduced costs and excellent value for money;
- D. An improved capacity to invest in infrastructure

6. The criteria also stated that the pools should take the form of ‘up to six British Wealth Funds’. It has subsequently become clear that the eight Welsh LGPS Funds (with combined assets of c.£13bn) are likely to be granted exemption from the ‘scale’ element due to their ‘unique culture, politics and regulations’. It looks highly likely that there will be an additional six pools covering England.

Activity since previous meeting of Local Pension Committee

- 7. At its meeting of 22nd January 2016 the Local Pension Committee approved a recommendation that the Leicestershire Pension Fund give a firm commitment to work with other funds that had collectively become known as ‘LGPS Central’. The other Funds were Cheshire, Derbyshire, Nottinghamshire, Shropshire, Staffordshire, West Midlands and Worcestershire and the combined assets of the pool at 31st March 2015 were c.£35bn.
- 8. The eight Funds have continued to co-operate well and an initial response to the Government’s proposals was sent by both the Leicestershire Fund and LGPS Central before the deadline of 19th February 2016. A letter from the Minister for Local Government was sent to all Funds within LGPS Central in late March 2016, a copy of which is attached as an appendix. Leicestershire did not actually receive a letter, and no representative of Leicestershire was included in the circulation list, but the Minister has assured us that this was an administrative oversight and the letter should be taken to cover all eight members of LGPS Central including Leicestershire. This response is broadly supportive and includes paragraphs that were common to most of the letters that went out to the other prospective pools.
- 9. LGPS Central, alongside some of the other prospective pools, had already commissioned legal opinion on the best legal structure for an investment pool prior to the response of the Minister. This opinion made it clear that a formal Common Investment Vehicle (CIV) was the most appropriate structure both from a legal perspective and also to meet the wishes of government.
- 10. The alternative structure, generally referred to as a Common Asset Pool (CAP), has no formal legal standing and is effectively an informal agreement to manage assets on a joint basis. Whilst this arrangement avoids the cost and difficulties of regulation by the Financial Conduct Authority (FCA), there is a very real possibility that its activities may inadvertently stray into areas in which regulation is a requirement. This would lead to fines and potential imprisonment and the risks surrounded a CAP are significant, so can be discounted as inappropriate.
- 11. A number of the prospective pools have explored, and continue to explore, ways in which they can avoid the need for Regulation. The government is firmly against unregulated pools, as can be seen in the third paragraph of the response from the Minister in the appendix. As LGPS Central will have an internal management company as part of the options available for Funds, there is an inherent need for Financial Conduct Authority regulation for this company and the ‘step up’ to FCA

registration for the whole pool is not as challenging as it will be for the pools without internal management capability. Whilst going through this regulation process, and the need to prove that the pool has sufficient resource to cover all areas that are required to meet the stringent requirements of the FCA, will be time consuming and incur costs that the Funds do not currently have. By properly regulating pools, it will prove that robust practises are in place – for a pool that will ultimately be responsible for managing £35bn of assets (and probably more, on the basis of future investment growth), the government's wish to see regulation does not seem unreasonable.

12. As a separate piece of work to the legal opinion mentioned above, LGPS Central has also commissioned assistance in considering the options for the structuring and ownership of the pool. There is a requirement for the pool to have an 'operator' to run the pool and there are three options in this respect:
 - (i) Buy an existing operator that already has the necessary infrastructure and expertise in place;
 - (ii) To 'rent' the services from an existing operator;
 - (iii) To 'build' a new operator.
13. Buying an existing operator is not really practical given how few there are in existence and given the scale of LGPS Central, which would dwarf the assets managed by most existing operators.
14. Renting is an option but the issue of scale is still a concern, as is the loss of control in certain key decisions – for example the choice of underlying investment managers. Renting is likely to reduce the up-front costs that need to be incurred in the 'build' option – for example, FCA authorisation will already be in place – but will be more expensive on an on-going basis. Although the Funds will have certain powers as investors, the ability to influence the operator is necessarily low as financial regulation requires the operator to retain independence of action in many areas – investors cannot run an operator by proxy.
15. The build option is considered to be the most sensible, given the circumstances of LGPS Central. This will give the Funds maximum influence in terms of the investment options offered within the pool, and control over the appointment of key individuals within the operator. The operator will be owned by the Funds and the Funds will have shareholder rights, as well as investor rights. Building is a more costly and more onerous option in the short term, but in the long-term allows maximum flexibility and will be more cost effective. The operator will, however, be run autonomously but with oversight governance from the Funds.
16. The next key date for LGPS Central is 15th July 2016, when a final submission is required. It has been agreed that this submission will take the form of a template answering set questions, with the ability to include further detail via the use of appendices. The template is currently being agreed by all parties but the initial draft suggests that it will be reasonable in its requests for information, and recognise that there has been a limited amount of time for pools to agree detailed plans in certain areas (the investment options that will be available via the pool, for example). One area within the template is an expectation that all funds within a pool will have agreed, via due political process at the appropriate committee, certain key features

of their proposal. One of the key areas will be the preferred legal structure and the governance arrangements that are expected to be in place.

17. The requirement for formal agreement of some matters by the Local Pension Committee means that it will be necessary to hold a special meeting of this committee before the end of June – whilst officers of all eight Funds continue to meet regularly (on at least a fortnightly basis), there is a lot of detail that still needs to be worked through before a form of wording for committee approval at each Fund can be agreed. Officers of the Funds continue to work together extremely well and their views are very closely aligned, but there are still considerable amounts of work to be done.
18. LGPS Central has already carried out important work in respect of the current investment strategies of each Fund, and the total investment costs incurred by these strategies. All Funds are aware that the Pool cannot simply replicate what we currently have if meaningful savings (and savings that will be greater than the additional costs incurred in operating the Pool) are to be achieved. All Funds will have to compromise and be willing to look at alternative ways of meeting their required investment returns, but the signs are that this will happen. Third parties that have had dealings with some of the other pools suggest that LGPS Central has greater unity than some of the other prospective Pools, which may simply be a function of having fewer Funds than some, but there will undoubtedly be sticking points that arise over the coming months and years. There is a strong expectation that any differences can be worked through.
19. Then government, via the Department for Communities and Local Government (DCLG) and Her Majesty's Treasury (HMT), continue to engage with Pools in a meaningful way and to offer useful feedback into their thinking and requirements. Meeting between LGPS Central and these bodies have been very positive and there is a strong expectation that LGPS Central will be one of the Pools that is accepted following the July submission, and that there will be relatively few changes to this submission required by Central Government.

Summary

20. LGPS Central continues to progress steadily and in an efficient manner, and meeting the requirement of a detailed submission by the Pool by 15th July 2016 is well in hand. Officers of all eight funds are strongly supportive of the fact that the Pool should take the form of an entity (or entities) that are authorised by an appropriate regulator, and this is in line with the government's clearly articulated wishes.
21. The LGPS Central Pool has to be run by an 'operator' and there are clear long-term advantages, both financial and from an operation and governance perspective, for this operator to be 'built' and owned by the eight Pension Funds. Whilst this is a very meaningful commitment from the Funds, the scale of the assets is such that it is possibly the only sensible option.

Recommendations

22. That the Committee notes the report.

Equal Opportunities Implications

None specific

Background Papers

Local Pension Committee – 22 January 2016 – Local Government Pension Scheme Investment Reform

[http://politics/Published/C00000740/M00004490/AI00046596/\\$InvestmentReform.docA.ps.pdf](http://politics/Published/C00000740/M00004490/AI00046596/$InvestmentReform.docA.ps.pdf)

Appendix

Letter from the Minister for Local Government

Officers to Contact

Colin Pratt – telephone (0116) 305 7656

Chris Tambini – telephone (0116) 305 6199

This page is intentionally left blank