Local Government Pension Scheme: Draft Statutory guidance on asset pooling

This note provides factual information relating to the Ministry of Housing, Communities and Local Government's informal consultation on the Draft Statutory guidance on asset pooling. This note is addressed to the Fund's Officers and Committee(s). It is not for public distribution.

Timetable

The consultation was issued on 3 January 2019, it is open for 12 weeks and will close on 28 March. It is deemed an informal consultation which is addressed to *"interested parties only, including the Scheme Advisory Board, Pensions Committees, Local Pension Boards, the pool Joint Committees or equivalent, the Cross Pool Collaboration Group, the pool operating companies where owned by participating funds, CIPFA and ALATS".* The SAB secretariat will be assisting MHCLG with the consultation but all responses should be sent to LGPensions@communities.gov.uk.

Background

The guidance sets out the requirements on administering authorities in relation to pooling assets and replaces "*the section at pages 7 to 8 of Part 2 of Guidance for Preparing and Maintaining an Investment Strategy, issued in September 2016 and revised in July 2017, which deals with regulation 7(2)(d) of the 2016 Regulations. It also replaces Local Government Pension Scheme: Investment Reform Criteria and Guidance, issued in November 2015."* As a reminder, we attach links to the replaced documents at the foot of this document[1].

Overview

Further to the introduction the consultation is broken into 7 sections which we set out below. As outlined in the title, the governance is statutory. Throughout the document, there is frequent use of certain words, in particular "must", "should" and "may" in relation to different points being made. Each highlights the extent to which adherence is expected.

Definitions

This section sets out a number of definitions relating to pooling, including,

'Pool governance body' the body used by pool members to oversee the operation of the pool and ensure that the democratic link to pool members is maintained (for example, Joint Committees and officer committees).

'Pool company' the Financial Conduct Authority (FCA) regulated company which undertakes selection, appointment, dismissal and variation of terms of investment managers, and provides and operates pool vehicles for pool members.

'Pool fund' a regulated unitised fund structure operated by a regulated pool company, such as an Authorised Contractual Scheme (ACS).

'Pool member' an LGPS administering authority which has committed to invest in an LGPS pool and participates in its governance.

It also defines Pool vehicles, retained assets and local assets which are all covered in later sections of the consultation.

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1 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/479925/criteria_and_guidance_for_investment_reform.pdf http://lgpslibrary.org/assets/statgui/ew/201609ISS.pdf http://lgpslibrary.org/assets/statgui/ew/201707ISS.pdf

Structure and scale

This section reiterates the aims of pooling, that all administering authorities must pool their assets and that pool members must appoint a pool company or companies to implement their investment strategies, stating clearly, *"It is for the pool companies to decide which investment managers to use for pool vehicles"*. It also states that a pool company must be a company regulated by the FCA

It is stated that Pool governance bodies, working with the Pool company, "*should regularly review the provision of services to the pool, and the process of procurement, to ensure value for money and cost transparency*" and *"the balance between active and passive management in the light of performance net of total costs. They should consider moving from active to passive management where active management has not generated better net performance over a reasonable period*".

Governance

It was stated that pool governance bodies must be established in order to "set the direction of the pool and hold the pool company to account" while pool members through their own governance arrangements will be "*responsible for effective governance and for holding pool companies and other service providers to account*". In addition "*Strategic asset allocation remains the responsibility of pool members*". It also states Pension Committees should take a long term view of the potential benefits of pooling, taking into account "*the benefits across the pool and across the scheme as a whole…and should not seek simply to minimise costs in the short term*." It also notes that Pension Boards can have a role in governance arrangements.

It also states that part of pool governance bodies' role is to decide the pool's policy on which aspects of asset allocation are "*strategic*" and which are "*tactical*", with the guidance stating that, "*governance bodies should be mindful of the trade-off between greater choice and lower costs*". It is also noted that the position between what is deemed strategic and what is tactical is something that might change over time. It is also states that, "*Pool members should set out in their FSS and ISS how they, through the pool governance body, have balanced these considerations and how they will keep this under regular review*".

Transition of assets to the pool

There are a number of comments on treatment of costs, including

"Transition of listed assets should take place over a relatively short period." and *"..should see to minimise transition costs to pool members while effectively balancing speed, cost and timing, taking into account exit or penalty costs and opportunities for crossing trades."* And *"Inter-authority payments (or other transfers of value) may be desirable in order to share these costs equitably between pool members. The Government's view is that such payments are investment costs within Regulation 4(5) of the 2016 Regulations, and payments made by a pool member to meet its agreed share of costs may be charged to the fund of that pool member, whether the payments are made to other pool members, the pool company, or another body by agreement."*

It is noted that "*In exceptional cases, some existing investments may be retained by pool members on a temporary basis*" citing assets that need to be held to maturity as an example. It also notes that *"Pool members may also retain existing direct property assets where these may be more effectively managed by pool members"* and *"…pool members may retain the management of existing long term investment contracts where the penalty for early exit or transfer of management would be significant. These may include life insurance contracts ('life funds') accessed by pool members for the purpose of passive equity investment, and some infrastructure investments."*

For assets held outside the pool it is stated that, *"Pool members, working with the pool company, should undertake regular reviews (at least every three years) of retained assets and the rationale for keeping these assets outside the pool."*

Making new investments outside the pool

There is an expectation that new investments will be made through the pool company with 2020 being set as the target timescale and a statement that "*pool members should make new investments outside the pool only in very limited circumstances.*"

Exceptions (to pool members investing in their own pool) include,

"A small proportion of a pool member's assets may be invested in local initiatives within the geographical area of the pool member or in products tailored to particular liabilities specific to that pool member", with clarity that Local assets should*, "not normally exceed an aggregate 5% of the value of the pool member's assets at the point of investment and be subject to a similar assessment of risk, return and fit with investment strategy as any other investment.";* or "*may invest ….in a pool other than their own where collaboration across pools or specialism by pools can deliver improved net of fee returns"*

Infrastructure investment

There are a number of infrastructure related aspects noted in the document. Although supportive of the asset class, the consultation states, "*There is no target for infrastructure investment for pool members or pools, but pool members are expected to set an ambition on investment in this area."* "*Government expects pool companies to provide the capability and capacity for pools over time to move towards levels of infrastructure investment similar to overseas pension funds of comparable aggregate size*".

It is explicitly stated that Pools are expected to provide a range of options to accessing the asset class and may offer brown and greenfield exposure to the asset class. There is also comment that, "*Pool members may invest in their own geographic areas but the asset selection and allocation decisions should normally be taken by the pool company in order to manage any potential conflicts of interest effectively, maintain propriety, and ensure robust evaluation of the case for investment*". The consultation states for the purpose of annual accounts CIFPA's definition for the asset class should be used (which includes a comment that conventional property is not normally included). The consultation also makes it clear that residential property is defined as infrastructure.

Reporting

There are a number of cost and pooling related requirements, including stating that, *"Pool members are required to report total investment costs and performance against benchmarks publicly and transparently in their annual reports, following the CIPFA guidance Preparing the Annual Report, with effect from the 2018-19 report."*

The CIPFA guidance is also to be used when it comes to defining which assets are to be deemed pool assets, "*'pooled assets' are those for which implementation of the investment strategy – i.e. the selection, appointment, dismissal and variation of terms for the investment managers (including internal managers) – has been contractually, transferred to a third party out with the individual pension fund's control."* Pool members should *"provide a rationale for all assets continuing to be held outside the pool, including the planned end date and performance net of costs including a comparison which costs of any comparable pool vehicles. They should also set out a high level plan for transition of assets."*

It is stated that the SAB will publish an annual report on the pools based on data from the pool member annual reports. It is also stated that pool companies should report in line with the SAB Code of Cost Transparency, with pool companies requiring their internal and external investment managers to do likewise. The final point on the consultation is to state that *"Pool members are required to report any change which results in failure to meet the requirements of this guidance to the LGPS Scheme Advisory Board (SAB) and to MHCLG."*

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