

JOHN RAISIN FINANCIAL SERVICES LIMITED

London Borough of Barking & Dagenham Pension Fund

**Observations on the draft LGPS Statutory Guidance on
Asset Pooling issued 3 January 2019**

**A paper by the Independent Advisor
February 2019**

Background to the draft Statutory Guidance

In November 2015 the Government issued the “*Local Government Pension Scheme: Investment Reform Criteria and Guidance*.” This document provided guidance to the LGPS on the creation of Asset Pools. Based on this guidance the LGPS Administering Authorities across England and Wales came together to form eight Asset Pools. The Barking and Dagenham Fund chose to join the London CIV pool. The Statutory Guidance of July 2017 on “*Preparing and Maintaining an Investment Strategy Statement*” includes approximately a page on asset pooling but this is general/broad in nature and does not address issues that have arisen as Asset Pools have developed since 2015.

The experience of pooling since 2015 particularly in the context of the wide spectrum of approaches adopted by both the eight Asset Pools and by the (now) 87 LGPS Funds in England and Wales has necessarily resulted in the issuing of detailed new draft **Statutory Guidance on Asset Pooling** by the Ministry of Housing, Communities and Local Government (MHCLG) on 3 January 2019.

The consultation period is twelve weeks and will close on 28 March 2019. After consideration of responses to the Consultation the MHCLG will then proceed to issue actual **Statutory Guidance on Asset Pooling**.

Independent Advisor’s Opening Comments

The covering e mail which accompanied the draft Statutory Guidance included the statement “*As you may know, MHCLG has been preparing new statutory guidance on LGPS asset pooling. This will set out the requirements on administering authorities, replacing previous guidance, and builds on previous Ministerial communications and guidance on investment strategies.*”

New guidance on Asset Pooling is clearly required. The November 2015 Guidance was issued in the context of forming Asset Pools. Since then eight Asset Pools, which overall are clearly diverse in both their structure/governance and approach, have been formed and are now all operational. Consequently, new Guidance is needed in the light of experience, in response to issues that have arisen so far, and to help ensure Asset Pooling is genuinely effective and successful in the long term.

Furthermore, the Guidance issued in November 2015 does not have the status of Statutory Guidance. In contrast the 2019 Guidance when issued in final form will have the status of Statutory Guidance issued by the Secretary of State under Regulation 7(1) of the LGPS (Management and Investment of Funds) Regulations 2016. In simple terms Administering Authorities such as the London Borough of Barking and Dagenham must follow Statutory Guidance except where it judges on admissible grounds that there is good reason not to do so, but without the freedom to take a substantially different course. Consequently the 2019 Guidance when finalised will normally need to be followed by all LGPS Funds and will put in place a clearly defined framework for Asset Pooling.

This paper makes observations and comments on the draft Statutory Guidance issued on 3 January 2019 to assist the Pensions Committee to understand its potential implications. It also makes some suggestions as to how the draft might be amended and improved. Each area of the draft Statutory Guidance is examined in turn below:

Foreword

In this section *“the hard work and commitment of people across”* the LGPS in progressing all eight Asset Pools to operational status is acknowledged. It is also stated that *“In the light of experience to date with pooling and the challenges ahead.... The time is now right for new guidance to support further progress.”*

Introduction

The Introduction makes it clear that the guidance when finalised will be Statutory Guidance and includes the statement that *“This guidance sets out the requirements on administering authorities in relation to the pooling of LGPS assets..... Administering authorities are required to act in accordance with it.”*

Definitions

The guidance introduces a set of definitions *“for use in this and future guidance”* in relation to Asset Pooling – *Pool, Pool member, Pool governance body, Pool company, Pool fund, Pool vehicle, Pooled asset, Retained asset, Local asset.* These definitions are extremely helpful in clarifying the requirements and expectations of the MHCLG in relation to Asset Pooling.

Structure and Scale

Section 3.2 makes it clear that *“the selection, appointment, dismissal and variation of investment managers”* *“must”* going forward be a matter for the Asset Pool not individual Administering Authorities (LGPS Funds).

Section 3.4 states that a Pool Company (which is the body that undertakes the selection, appointment, dismissal and variation of terms of investment managers) *“must be a company regulated by the Financial Conduct Authority (FCA) with appropriate FCA permissions for regulated activities.”* This would appear to resolve the question as to whether or not each Asset Pool needs to set up/utilise an overarching FCA regulated company as part of its Governance arrangements.

Although seven of the eight Asset Pools, including the London CIV, have so far set up/utilised an overarching FCA regulated company the Northern Pool which consists of the Greater Manchester, West Yorkshire and Merseyside Funds (respectively the first, third and fourth largest of the 87 LGPS Funds in England and Wales) has not yet done so. The three Funds have made a very clear and cogent case, that due to their scale and their low costs, it is not cost effective for the Northern Pool to establish such an overarching FCA regulated company. They have, however, also previously stated that this will be regularly reviewed. In addition, they have established their own Private Equity vehicle and in partnership with the Local Pension Partnership Pool are the most advanced of the LGPS pools in respect of infrastructure through the FCA regulated GLIL vehicle. Given these facts the MHCLG appear to be unnecessarily imposing a *“one size fits all approach”* to Pool structures.

Section 3.6 requires individual LGPS Funds together with their Asset Pool to *“regularly review the balance between active and passive management....”* This is surely an unnecessary level of intervention in the activities of Administering Authorities and their Asset Pools.

Governance

Section 4 on Governance makes it absolutely clear that Asset Pools are and must be accountable to their constituent LGPS Funds stating that *“Pool members must establish and maintain a pool governance body in order to set the direction of the pool and to hold the pool company to account.”* This section also specifically states that it is the pool governance body that is ultimately, though in consultation with the Pool, responsible for deciding which aspects of asset allocation are strategic and should remain with the Administering Authority, and which are tactical and to be undertaken by the Pool. This confirms that Asset Pools, which exist only to serve their constituent LGPS Funds, should not seek to set the framework within which they interact with them.

Section 4 also includes the statement *Pool governance bodies should be appropriately democratic and sufficiently resourced to provide for effective decision making and oversight.”*

If the governance body is to be fully effective it clearly should be diverse in terms of experience and perspective leading to diversity of thought and the avoidance of “groupthink.” Therefore, it is surprising that the draft guidance does not state that Employee representatives “*should*” be included in the membership of pool governance bodies. This omission is even more surprising given both that the LGPS exists to provide pension benefits to those employed in local government (and organisations with a community of interest with local government) and the requirements of the Public Service Pensions Act 2013 and the LGPS Regulations 2013 (As amended) that Employee representatives must be included in the governance arrangements of LGPS Funds through their representation on Local Pension Boards. The insertion of a statement that pool governance bodies “*should*” include a proportion of Employee representatives (perhaps a third or a quarter) would clearly enhance the governance of Asset Pools by enhancing the diversity of experience and perspective of the membership of these bodies.

The LGPS Scheme Advisory Board for England and Wales (SAB) has previously indicated its support for the inclusion of Employee representatives on pool governance bodies. In May 2018 the SAB issued an updated Statement on Pool Governance which clearly encouraged “*the consideration of direct representation on oversight structures*” of Employee representatives and concluded with the statement that “***In line with the UK Corporate Governance Code principle of ‘comply or explain’, any pool making a decision to exclude member representatives from their formal oversight structures should publish this decision and formally report the reasons to the local pension boards which the pool serves.***” At present the London CIV Shareholder Committee (the London CIV pool governance body) membership consists of eight Councillors and four Treasurers. There are, however, no specific Employee nominated members of the Committee.

Section 4.1 of the draft Statutory Guidance includes the statement “*Pool members must establish and maintain a pool governance body in order to set the direction of the pool and to hold the pool company to account.*” That this body should be properly resourced is also clear from the draft Statutory Guidance as Section 4.1 also states that Pool Governance bodies should be “*sufficiently resourced*” to enable “*effective decision making and oversight.*” Given however that Pool Governance bodies such as the London CIV Shareholder Committee, unlike the Asset Pools, are not full time bodies there is a real possibility that they will lack the time, resourcing, advice and support to effectively “*set the direction of the pool and to hold the pool company to account.*”

It is therefore critical that as well as providing sufficient resources to the London CIV to enable it to carry out its allotted role the Shareholder Committee ensures that it has itself a sufficient level of resourcing and support to proactively set and then monitor the overall framework within which the London CIV operates. If there is a potential weakness in the Governance framework of Asset Pooling it is not the role of the Pool Governance bodies as set out in the draft Statutory Guidance. Rather, it is the possibility that Pool Governance bodies, such as the London CIV Shareholder Committee will meet too infrequently and without

sufficient resourcing/support and time to carry out their role properly and effectively. This must not happen if Asset Pools, such as the London CIV, are to genuinely facilitate the improved implementation of the Investment Strategy's of their constituent LGPS Funds.

Therefore, in relation to Pool Governance bodies, it is logical that the word "*must*" ought to be substituted for the word "*should*" in line two of Section 4.1. Additionally, the draft Guidance would be further improved if in the present third line of Section 4.1 after the word "*resourced*" wording such as "*in terms of professional advice, support and time,*" was added.

The fact that individual LGPS Funds remain responsible for strategic asset allocation is clearly stated at both sections 4.2 and 4.7. Section 4.2 includes the statement that "*Strategic asset allocation remains the responsibility of pool members, recognising their authority's specific liability and cash-flow forecasts.*" Section 4.7 includes the statement that "*Pool members are responsible for deciding their investment strategy and asset allocation and remain the beneficial owners of their assets.*"

It is extremely helpful to both individual LGPS Funds and their Asset Pools that the guidance is absolutely clear that investment strategy and strategic asset allocation remain the responsibility of the individual LGPS Funds. Given this clarity one potentially major issue that the draft Statutory Guidance is silent on is the provision of "*proper advice*" that individual LGPS Funds must take in formulating their Investment Strategy Statement under Regulation 7 of the LGPS (Management and Investment of Funds) Regulations 2016.

If an Asset Pool were to provide "*proper advice*" to its constituent LGPS Funds then the Pool will have a potentially decisive influence over the strategic asset allocations of the organisations it has been created to serve. This would be "the tail wagging the dog." Therefore, it is logical that a statement be included in the Statutory Guidance that Asset Pools "*must not*" provide "*proper advice*" to any Administering Authority in relation to decisions made under Regulation 7 of the LGPS (Management and Investment of Funds) Regulations 2016.

There is clearly a question as to which aspects of investment strategy are "*strategic*" and are therefore the responsibility of each individual LGPS Fund and which are, in the words of the draft Statutory Guidance "*tactical and best undertaken by the pool company.*" The draft guidance (Section 4.8) clearly indicates that the decision as to what is "*strategic*" and what is "*tactical*" is not a decision for the Asset Pool (for example the London CIV) but for "*Pool members collectively through their pool governance bodies*" which should however "*be mindful of the trade-off between greater choice and lower costs and should involve the pool company to ensure the debate is fully informed on the opportunities and efficiencies available through greater scale.*" Section 4.8 while requiring consultation with the Asset Pools is both a very clear statement and reminder that the Asset Pools exist to deliver services to their constituent LGPS Funds and that they must not seek to impose any interpretation of "*strategic*" and "*tactical*" investment on their constituent Funds.

Section 4.4 of the draft Statutory Guidance states that Members of Pension Committees should “*take a long term view of pooling implementation and costs.*” While this statement appears perfectly logical the statement which follows it does not. This reads “*They should take account of the benefits across the pool and across the scheme as a whole.....*” This reference to the pool and scheme as a whole is surely at odds with the primary responsibility of Pension Committee Members which is to their own LGPS Fund, its constituent Employers and their local taxpayers. This element of the draft Statutory Guidance appears inappropriate and should ideally be removed from the final version.

Transition of assets to the pool

This section is clear that individual LGPS Funds must implement asset pooling and leaves no discretion for individual LGPS Funds to unnecessarily or unduly delay the pooling of the vast majority of their assets. Such an approach is clearly necessary if the benefits of asset pooling to the LGPS as a whole are to be achieved.

The draft Statutory Guidance is however also clear that “*In exceptional cases, some existing investments may be retained by pool members on a temporary basis. If the cost of moving the existing investment to a pool vehicle exceeds the benefits of doing so, it may be appropriate to continue to hold and manage the existing investment to maturity before reinvesting the funds through a pool vehicle.*” (see section 5.4) and that individual LGPS Funds “*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.... some infrastructure investments.....*” (see section 5.5).

The sharing of transition costs using inter authority payments is expressly permitted by Section 5.3. This may, in some cases, help encourage and smooth the transition of assets from individual LGPS Funds to their Asset Pools.

Making new investments outside the pool

The contents of this section (see sections 6.1 and 6.4) seek to clarify and in effect minimise the ability of individual LGPS Funds to themselves procure asset manager services and includes the statement (see section 6.1) “*Pool members should normally make all new investments through the pool company in order to maximise the benefits of scale..... From 2020, when new investment strategies are in place, pool members should make new investments outside the pool only in very limited circumstances.*” These provisions are logical if the potential benefits of asset pooling to the LGPS as a whole are to be achieved.

The practicality of Section 6.1 will, however, be dependent upon the ability of Asset Pools to offer investment options to their constituent LGPS Funds to enable them to implement their own individual Investment Strategy. Given the

very limited progress made so far by Asset Pools, as a whole, in procuring investment products for their constituent LGPS Funds the timescale of 2020 for when *“only in very limited circumstances”* should LGPS Funds directly procure asset management services seems over ambitious. To ensure that Asset Pools do not seek to unduly rush procurements, and therefore potentially fail to meet the needs of the LGPS Funds they exist only to serve, it would be logical to replace “2020” with a later date, but not earlier than “2022.”

Section 6.3 states *“Pool members may invest through pool vehicles in a pool other than their own where collaboration across pools or specialisation by pools can deliver improved net returns.”* Although this section explicitly approves the principle that an LGPS Fund is not restricted to investing only through its own Asset Pool it is not clear as to how such cross Pool investment can be initiated. Section 6.3 should ideally therefore be expanded to explicitly indicate the process whereby a LGPS Fund can invest into a cross pool or specialised offering provided by another Asset Pool. It is suggested that wording such as the following might be added to Section 6.3 *“Where after having consulted with its own pool company an Administering Authority reasonably believes that a cross pool initiative or another pool can provide improved net returns in respect of a particular investment it may then seek to invest in it, after having formally informed its own pool governance body of its intention.”*

Infrastructure investment

This section clarifies that while asset pooling was intended to facilitate infrastructure investing and the government expects pools to provide increased *“capability and capacity”* for infrastructure investment *“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.....”*

Sections 7.4 and 7.5 provide a definition of infrastructure assets which (helpfully) is both clear and broad and confirms that *“all residential property is included in this definition of infrastructure.”*

Section 7.3 includes the statement *“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.”*

Reporting

To evidence whether, in quantitative terms, asset pooling has been successful, and, if so, to what extent then clear, extensive and robust reporting is necessary. Section 8.1 of the draft Statutory Guidance therefore requires that each LGPS Fund report a wide range of data (see sections 8.2 and 8.3) *“..... publicly and transparently in their annual reports”* following CIPFA guidance.

Section 8.3 states that *“Investments should be classed as pool assets on the basis of the definition in the CIPFA guidance Preparing the Annual Report.”* This definition is however not exactly the same as that of a *“Pooled asset”* as set out in the Definitions section 2.1 of the draft Statutory Guidance. Clearly the MHCLG should, before issuing the final Statutory Guidance, ensure there is no conflict between Sections 2.1 and 8.3.

Section 8.7 clearly and explicitly indicates the importance that the MHCLG attaches to investment cost transparency stating *“Pool members should ensure that pool companies report in line with the SAB Code of Cost Transparency. They should also ensure that pool companies require their internal and external investment managers to do so.”*

Independent Advisors Conclusion

The draft Statutory Guidance is, as a whole, positive and helpfully provides definition and clarity in respect of a number of important issues relating to Asset Pooling. There are, however areas where the draft Guidance appears either unnecessarily prescriptive or incomplete.

Given the profile that Asset Pools have already achieved it is both timely and welcome that the draft Statutory Guidance unequivocally confirms that Asset Pools exist to effectively implement the investment strategy of each of their constituent LGPS Funds and that the Asset Pools should not seek to set the framework within which they interact with them.

For LGPS Funds to effectively govern their Asset Pool, and to avoid in effect been governed by it, it is essential that they establish and operate an effective pool governance body to set the direction of the Pool and to hold the Pool company to account. This may be a challenge but it is absolutely essential if asset pooling is genuinely to deliver benefits to individual LGPS Funds.

John Raisin

28 February 2019

John Raisin Financial Services Limited
Company Number 7049666 registered in England and Wales.
Registered Office 130 Goldington Road, Bedford, MK40 3EA
VAT Registration Number 990 8211 06

“Strategic and Operational Support for Pension Funds and their Stakeholders”

www.jrfspensions.com