

CABINET

8 April 2014

Title: Local Government Pensions Scheme - London Collective Investment Vehicle	
Report of the Cabinet Member for Finance	
Open	For Decision
Wards Affected: None	Key Decision: No
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Accountable Director: Jonathan Bunt, Chief Finance Officer	
Summary: <p>This report presents details of a proposal, supported by the Council's Pensions Panel, for the establishment by London Councils of a collective investment vehicle, in the form of an Authorised Contractual Scheme, for local authority pensions in London. This Council is being asked to participate by becoming a shareholder in the ACS Operator and contributing £1 to the ACS Operator as initial capital. It is also asked to appoint an elected member(s) who will have power to act for the Council in exercising its rights as a shareholder of the ACS Operator.</p> <p>Expert legal and financial services advisors were appointed by London Councils to develop a robust business case and a formal proposal to proceed with implementation of a London LGPS Collective Investment Vehicle (CIV), in the form of a UK based Financial Conduct Authority (the FCA) Authorised Contractual Scheme (ACS).</p> <p>The London Councils Leaders' Committee recently agreed to take recommendations to their boroughs in respect of agreeing to proceed with establishing an ACS and the ACS Operator, which is the company that would manage it.</p> <p>The financial case for a CIV is strong as cost savings can be made even at relatively low levels of participation, whilst at the same time practical proposals for the governance structure are being formulated. It should be noted that the proposals outlined in this report are based on voluntary participation, and the decision as to whether to invest in the ACS would be made later in the year. Therefore nothing proposed in this report locks the Council into any level of commitment to invest at this point.</p> <p>Dialogue with HM Government relating to its review of Local Government Pension Schemes is ongoing, and they are apprised of the progress made to date by London Councils. An announcement on this is awaited but it is known that CIVs are considered to be one of the ways forward.</p> <p>All London local authorities are being asked to respond in writing to the London Councils Chief Executive, by 14 April 2014, or before the day of the local government elections (22 May 2014) to confirm whether they wish to participate.</p>	

Recommendation(s)

The Cabinet is recommended to:

- (i) Agree that the Council participates in the proposed London Councils Collective Investment Vehicle as set out in this report, in the form of an Authorised Contractual Scheme (ACS), and the incorporation of a private company limited by shares to act as the ACS Operator for local authority pensions in London;
- (ii) Agree that the Council participates in the representative body, pursuant to the existing London Councils Governing Agreement, and to delegate to that representative body those functions necessary for the functioning of the ACS Operator, including effective oversight and appointment of Directors;
- (iii) Agree to become a shareholder in the ACS Operator and to contribute £1 to the ACS Operator as initial capital;
- (iv) Appoint the Leader to act for the Council in exercising its rights as a shareholder of the ACS Operator, and the Cabinet Member for Finance as the nominated deputy; and
- (v) Authorise the Head of Legal and Democratic Services to carry out steps and execute such documents and agreements as may be required to establish the Council's functioning membership in due course of the London Collective Investment Vehicle and ongoing participation.

Reason(s)

To assist the Council in achieving its Policy House theme "A Well Run Organisation" and achieve economies of scale through collaborative working with other local authorities.

1. Introduction and Background

- 1.1 At its December 2013 meeting, the London Councils Leaders' Committee received a progress update from its Pensions Working Group (PWG), which outlined the views and recommendations of the PWG in respect of the potential London LGPS Collective Investment Vehicle (CIV).
- 1.2 Following discussion, the Leaders' Committee agreed the recommendations of the PWG that a business case and formal proposal should be prepared to proceed with implementation of a CIV and that this should be structured as a UK Authorised Contractual Scheme (ACS).
- 1.3 The Leaders' Committee also commissioned the PWG to engage expert legal and financial services advisors to assist in the development of the ACS and its Operator. These advisors, Eversheds, Deloitte and Northern Trust as a Custodian advisor, have been appointed and further analysis has been undertaken on the legal, regulatory, and financial aspects of implementing the CIV. A robust business case is being prepared to inform the formal proposal to proceed with implementation of the ACS and its Operator.

- 1.4 At its 11 February 2014 meeting the Leaders' Committee agreed to take questions to their boroughs as to whether they agree to the next steps in the formation of the ACS and its Operator.
- 1.5 This report recaps the financial benefits which may arise from operating an ACS, and sets out details of the expected costs. It also summarises the proposed structure of the ACS and potential governance arrangements (including the ACS Operator), together with the steps that are required to progress the project and establish the ACS and its Operator. The decision as to whether to invest in the ACS will remain with the Council and any decision would not be made until the autumn at the earliest.
- 1.6 The 33 London LGPS funds currently have over £20bn of assets under management. Previous reports have noted that some of those funds deliver performance that is amongst the best, some of the funds are performing less well, and all funds are facing the challenging environment of volatile asset performance and increasing liabilities. This is a picture reflected across the UK.
- 1.7 The Government issued a call for evidence on the future structure of the LGPS last year, and sought professional advice to consider either Collective Investment Vehicles or merger of funds as potential routes forward. This advice, being provided by Hymans Robertson and Government consultation are expected to be published shortly. Informal indications are that, while undoubtedly whatever is published will need to be considered it seems unlikely that the direction of travel towards a London CIV will be fundamentally challenged.
- 1.8 The London Councils' work precedes this call for evidence. In 2012, a report from the consultants PricewaterhouseCoopers for the Society of London Treasurers' set out options for reconfiguring the London LGPS funds, and indicated the possible financial benefits of a CIV. Since then, the matter has been discussed several times, and it has been agreed that creating a CIV should be considered further, and that the most appropriate structure for the CIV would be an ACS. The Council was one of a number of authorities which, through the Council's Pension Fund (the Fund), agreed to contribute £25k towards exploring the proposal, and a designated fund of these contributions has been established. The contribution will fund the professional costs associated with development of the proposed ACS and its Operator.

2. Financial Case

- 2.1 In considering the financial case, there are a number of areas being considered. The potential financial benefits of the ACS, and its ongoing costs and costs of establishment are considered in detail below, with a high level summary appended.

2.2 Financial benefits

- 2.2.1 The 33 London LGPS funds currently have over £20bn of assets under management. Previous work undertaken by PricewaterhouseCoopers estimated savings in the region of £120m per annum from the creation of a CIV, provided there was close to full participation by authorities. The current analysis affirms this calculation.

2.2.2 The primary cost savings previously identified were in respect of lower investment management fees. Improved performance, whilst anticipated, cannot be guaranteed and is not a cost saving as such. Work since then indicates that there may be further savings in other areas. For example, when investing in a third party fund, it is likely that income from activities such as stock lending and foreign exchange will be earned, however may not be passed on to the LGPS, as investors, to the same level as could be possible in the ACS where the participating Councils also act as the ACS Operator. PWG estimated that the income from these activities could be in the region of 0.1 to 0.2%. There is no current information available about the level of return that is currently allocated to LGPS in relation to their existing investments.

2.3 Custody costs

2.3.1 The main cost associated with running the ACS is from the custody of the assets. Custody costs are calculated as a basis point fee on the amount of assets, with the basis point fee reducing on a sliding scale as the amount of assets under custody increases. For assets of £1bn or less, the cost may be relatively high, at 0.1% of assets under management. At around £6bn of assets, the custody costs would be in the region of 0.05%. For assets in excess of £14bn, the costs are lower still, estimated to be 0.035% of assets under management.

2.3.2 A reasonable minimum target size of assets under management for the ACS is considered to be in the range of £5bn of assets. This is based on work undertaken by the PWG, which shows that there are a number of boroughs who currently have very similar investment mandates with exactly the same investment managers. This research suggests that if 6 of the largest similar mandates with identical investment managers across a range of passive and active equity and bond mandates were selected in the ACS, scale of around £3bn could be achieved without any individual borough pension funds materially changing their currently selected mandates or manager. On the assumption that a number of other London boroughs would also be minded to invest in the ACS if it offered these mandates and given the initial interest expressed by boroughs in participating, a minimum target size of £5bn appears a reasonable assumption.

2.3.3 At a level of assets of £5bn the additional custody costs would be expected to be in the range of 0.03 to 0.04% (or £1.5 to £2m), being an ACS custody cost of 0.05% less the 0.01 to 0.02% which would have been incurred on existing investments.

2.4 Other costs and benefits

2.4.1 Other on-going costs of the ACS may include staff costs, consultancy fees and administration costs including audit and taxation. These fees would be charged directly to the Fund, as they would be now. Consultancy fees include professional advice on investment manager selection and compliance with the Financial Conduct Authority (FCA) Rules. As this would be performed centrally at the ACS level rather than multiple times at individual borough level, it is likely that savings would be achieved in this regard. Administration costs would not be expected to be significant compared to the benefits identified.

2.4.2 In relation to staff costs, on the basis that it is expected that a majority of functions may not be full time and might be performed by existing local authority personnel,

additional staff costs are not expected to be significant. For the purposes of the cost benefit analysis undertaken, an estimate of £400,000 has been made.

2.4.3 There are a number of roles required, and the precise detail of the final establishment of the ACS Operator will need to be confirmed later. To the extent that resource is not available, either from within London Councils or seconded from boroughs, additional third party or professional costs may be incurred. It is anticipated that these costs will be analysed in due course once the key roles have been more fully defined and the availability of suitable internal resources have been considered.

2.5 Establishment costs

2.5.1 There will be a number of establishment costs incurred in setting up the ACS Operator and the ACS.

2.5.2 These will be one-off costs in the first year, with £600,000 already contributed to by a number of London boroughs, in order to engage professional advisors to perform the necessary financial and regulatory work. It is currently expected that this work will be performed within this existing budget. However the costs for working on the detailed workings of the various committees and their interaction with ACS Operator, and any arrangements between the participating Councils as shareholders in the ACS Operator, have not been factored into to cost estimates given so far.

2.5.3 As the project progresses, additional professional fees are likely to be incurred (i.e. to assist in training relevant individuals on their regulatory roles and to assist in the development of procedure manuals). It will become clearer in due course where costs may arise in this regard.

2.5.4 There are expected to be costs of transition of assets to the ACS as assets are moved from existing managers to new managers appointed to the ACS. To a large extent, pension funds already incur similar costs as they transition assets to different managers in the ordinary course of their pension activities. As such these costs may well simply offset existing costs incurred although this depends on the level of fees currently charged and the number of transitions. Until further decisions are taken on the mandates that will be launched in the ACS, it is difficult to estimate accurately what these costs might be.

3. Proposed Structure

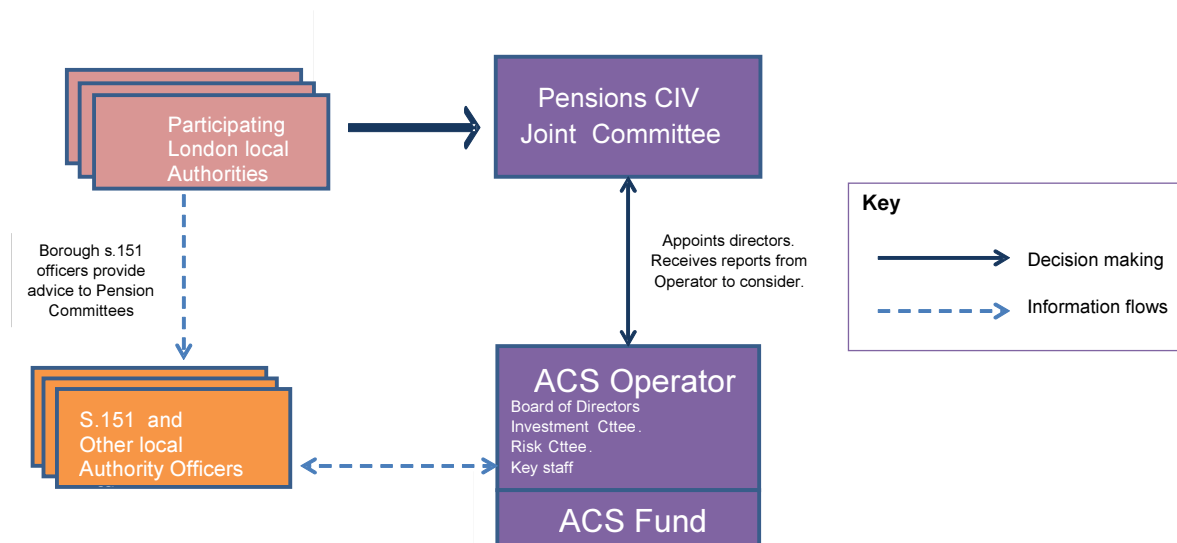
3.1 It was previously agreed that the most appropriate structure for the CIV is a UK based FCA authorised ACS fund, and nothing has emerged to suggest that that recommendation should change. During the ACS establishment process, some regulatory clarifications will be required although it is not currently expected that there will be any material difficulties. In particular, it will be important to confirm that no changes will be made that would prevent any LGPS from investing substantially all of its assets in a single ACS vehicle. Restrictions currently apply to certain other investment vehicles such as unit trusts and Open-ended investment companies and accordingly it will be important to confirm that changes to legislation will not be put in place that would impact the operation of the ACS, or that the legislation is amended to carve out from those restrictions ACSs operated by local authorities.

- 3.2 The ACS will require a FCA regulated ACS Operator to be established. Typically this is in the form of a limited liability company which is proposed here. The board and employees of this company will be responsible for the overall operation of the ACS, including its investment management. The composition of the board and its activities will need to comply with FCA regulations.
- 3.3 It is proposed that shares in the ACS Operator are owned by the participating local authorities. Initially, this would require boroughs that wish to participate at this stage to make a £1 investment in the share capital of the ACS Operator. At a later date, additional capital will be required for the ACS Operator to meet its regulatory capital obligations. It is currently expected that this capital will be invested by those boroughs that wish to make a pension investment into the ACS. No further capital would be required from any boroughs who participate at this stage but whose pension funds subsequently choose not to invest in the fund; indeed such boroughs could transfer their interests to those participating boroughs. Further details of how capital investments would need to be made for boroughs that choose to invest pension money will be considered in due course.

4. Governance structure of the ACS Operator

- 4.1 The process for governance and decision making has been considered in some detail, and there are a range of options for how the governance arrangements could be structured. The precise arrangements would always be open to members' scrutiny and amendment, and subject to FCA requirements, but what is laid out below is seen as sensible initial proposals to take the project forward at this point.
- 4.2 It is proposed that a new joint committee ('Pensions CIV Joint Committee') will be established under the existing London Councils framework and would be made up of the Leaders of those councils participating in the ACS. Should all the boroughs participate, this role would be performed by London Councils' Leaders' Committee. In relation to the make-up of this committee, it is proposed that boroughs that agree to become a shareholder in the ACS Operator would appoint a representative who will sit on this committee and with the power to act for the local authority in exercising its rights as a shareholder of the company. London Councils view is that whilst typically the borough Leader might be appointed as the representative on the joint committee, in the event that meetings are required to deal with specialist matters e.g. discussions on investment matters, it may be that a person with appropriate expertise would act as a deputy to attend such meetings, e.g. for investor matters; elsewhere it is envisaged that, the Chair of the Pension Panel could be appointed.
- 4.3 One of the main purposes of the Pensions CIV Joint Committee will be to act as a forum to recommend the key members of the board of the ACS Operator. The ability to appoint directors of the ACS Operator rests with the shareholders (who in practice, will be the members of the committee) and analysis is currently on-going to determine the most appropriate methodology for the wishes of the committee to be executed in a manner which is acceptable given various constraints that exist within local government, Companies Act 2006 requirements and FCA regulations.

4.4 The governance arrangements and lines of communication between various interest parties have been considered. The proposed arrangements in this regard are illustrated in the diagram below.



4.5 The exact mandate of the joint committee will require further consideration. The joint committee could make decisions in relation to the running of the ACS. There are a range of options in this regard, from making decisions on a limited number of matters, for example changes to capital and appointment and removal of directors, to taking decisions on a wide range of matters, such as investment strategy and choice of investment managers for the ACS. It is expected from a regulatory perspective that the mandate of the joint committee will be on a limited number of matters. The frequency of meetings of the joint committee would also need to be decided.

4.6 It is proposed that up to three members of the joint committee could be directors of the ACS Operator. The directors have to be approved by the FCA and will have fiduciary duties and responsibilities. The decision as to who could be in these roles is to be decided. It is not a requirement for the elected councillors sitting on the joint committee to have any director roles, and this will be one of the early matters on which the initial participating boroughs to join the joint committee and participate in the ACS will be asked to decide.

4.7 It is intended that at this stage the company should be established with interim directors, with formal appointments for the ongoing directors made in the autumn, prior to FCA approval. London Councils has proposed that, subject to no impediment for the individuals, the members of the Pensions Working Group should be asked to take the roles of interim directors, augmented with by the Chief Executive of London Councils. For clarity that would be Mayor Pipe (LB Hackney), Councillors O'Neill (LB Bexley) and Dombey (LB Sutton), Mr. Chris Bilsland (Chamberlain, City of London), Mr. Chris Buss (Finance Director, LB Wandsworth), Mr. Ian Williams (Finance Director, LB Hackney), and Mr. John O'Brien (Chief Executive, London Councils).

5. Next Steps

- 5.1 Broadly, if a sufficient number of boroughs agree to participate in the joint committee, the following steps will be undertaken:
- a. If required, a new sectoral joint committee will be established under the relevant Act and agreements. To the extent all 33 boroughs wish to participate at this stage, London Councils Leaders' Committee would fulfil this role instead.
 - b. The ACS Operator will be established, with participating councils each having £1 of share capital in the ACS Operator, and initial directors appointed, as set out above.
- 5.2 Further work will be undertaken regarding the design and operation of the ACS Operator and the ACS, the ongoing costs, and the documents required by the FCA to become authorised, such that when authorities reconvene following local elections, the draft documentation supporting the application can be presented, with authorities at that point being asked to commit to invest in the ACS.

6. Consultations

- 6.1 Decision making for the Council's Pension Fund has been delegated to the Pensions Panel and they have been kept informed of developments surrounding more collaborative working for the Pension Fund and also on the progress of the London Collective Investment Vehicle. The Pensions Panel have approved an initial contribution towards the set up costs of the CIV and provided support in terms of management resource to the project.

7. Financial Implications

Implications completed by: Jonathan Bunt, Chief Finance Officer

- 7.1 London Councils have considered in detail the business case for the establishment of a CIV and the potential for cost savings for Pension Funds across London. The proposals have received wide spread support with over 70% of London Boroughs being prepared to commit funds to see the CIV established, with only one authority indicating that they are not interested and the remainder wanting to see more detail before committing funds.
- 7.2 There is the potential to see significant financial benefits from greater collaboration amongst pension funds and the formation of a CIV will enable these to be delivered without the need for merger which itself could prove to significantly increase costs in the short term. It has been estimated that cost savings across London under a CIV could be as high as £120m and it is anticipated would help to deliver some of the savings that CLG are seeking from LGPS funds. The benefits of the CIV are that it will enable the cost savings to be delivered whilst continuing to enshrine the key objectives of maintaining local accountability and decision making for individual local authority pension funds. A collaborative approach provides opportunities to potentially invest in types of assets that smaller individual funds may not be able to easily access, for instance direct investment in appropriate infrastructure projects, which is also a particular focus for the current government.

- 7.3 There are clearly risks attached to the project given that funds need to be committed to establish the CIV, £25,000 to date, however these are relatively minor in the context of the Council's £655m Pension Fund, would be offset by the cost savings which can be delivered going forwards. The risks of inaction or non-participation in this collaborative venture are seen as far more significant, particularly if the outcome were to be a merger of funds which could see decisions being taken by external bodies and resulting in loss of accountability and potential to increase costs to local taxpayers.

8. Legal Issues

Implications completed by: Paul Feild Senior Corporate Governance Lawyer

- 8.1 This report asks Cabinet to agree to the Council participating in the establishment of a Collective Investment (CIV) in London. The purpose of which is to enable Pension Funds in London to access fund managers on the CIV platform efficiently should it be deemed appropriate for the Council to do so.
- 8.2 A company limited by shares will be incorporated to be the Authorised Contractual Scheme Operator (ACS Operator) of the CIV.
- 8.3 This report asks Cabinet to agree to the Council becoming a shareholder of the ACS Operator and to contribute £1 as initial capital in the ACS Operator.
- 8.4 The report also asks Cabinet to agree to the Leader to exercise the Council's shareholding rights in the ACS Operator.
- 8.5 The report asks Cabinet to agree to the establishment of the Pensions CIV Joint Committee to act as a representative body for the Local Authorities participating in the arrangements pursuant to the existing London Councils Governing Agreement dated 13 December 2001 as amended.
- 8.6 As the decision about whether to participate in the incorporation of the ACS Operator or become a shareholder in the company and how to exercise shareholder rights in it are executive functions, Cabinet is asked to agree to the delegation of those functions necessary for the proper functioning of the ACS Operator to this Joint Committee including the effective oversight of the ACS Operator and the appointment of its Directors.
- 8.7 The general power of competence in Section 1 of the Localism Act 2011 gives a local authority power to do anything that individuals of full capacity may generally do. The Council has power under Section 1 of the Localism Act to participate in the establishment of the CIV and the incorporation of the ACS Operator. Pursuant to the general power of competence, the Council can contribute to the initial capital of the ACS Operator and become one of its shareholders.
- 8.8 Sections 101 and 102 of the Local Government Act 1972 and section 9EB of the Local Government Act 2000 gives Local Authorities power to set up a representative body to act on their behalf. London Councils has an existing Governing Agreement dated 13 December 2001, as amended, through which the representative body, the Pensions CIV Joint Committee will be set up. This

Governing Agreement sets out the Standing Orders, Financial Regulations and the administrative framework under which all London Councils' activities operate.

- 8.9 Section 101 of the Local Government Act 1972 and Part 4 of the Local Authorities (Arrangements for the Discharge of Functions) (England) Regulations 2012 allow Cabinet to delegate the functions necessary for the proper functioning of the ACS Operator to the Pensions CIV Joint Committee.

9. Other Implications

- 9.1 **Risk Management** - The Pensions Panel is the body charged with the governance of the Council's Pension Fund and as such has to consider the balance between risk and reward for any investment decisions which it makes. Consideration of whether participation in the London CIV is appropriate for the Pension Fund has been part of the decision making process for the Panel. Whilst there is some financial risk to the Fund in terms of the costs of contributing to the setting up of the CIV, these are deemed to be minimal in the context of up to £25,000 compared to a Pension Fund valued at £655m.

The decision on whether to invest Fund money into the CIV, will be made by the Pensions Panel once the vehicle has been established and there are investment funds into which the Council's Fund can place its assets. A full assessment of options will be made at that time as to whether the investment into the CIV remains appropriate for the Fund. This will include consideration of the returns available, cost reductions available and associated risks, in line with all other investment decisions that are made by the Pensions Panel.

Public Background Papers Used in the Preparation of the Report: None

List of appendices:

Appendix 1 – Possible costs and savings at different levels of participation in the CIV