



Report – Policy and Resources Committee London Councils: London Local Government Pension Scheme (LGPS) Collective Investment Vehicle

*To be presented on Thursday, 6th March 2014
To the Right Honourable, The Lord Mayor, Aldermen and Commons
of the City of London in Common Council assembled.*

Summary

London Councils has undertaken work on the potential for more collaboration between a number of London boroughs and the City of London Corporation on the management and investment of pension funds. Expert legal and financial services advisors were appointed 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 FCA Authorised Contractual Scheme (ACS).

London Councils Leaders' Committee recently considered the outcome of this and agreed to take recommendations to London boroughs (and the City Corporation) to proceed with establishing an Authorised Contractual Scheme (ACS), and the ACS Operator, which is the company that would manage it. 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. It should be noted that nothing proposed in this report locks the City Corporation into any level of commitment to invest at this point.

Dialogue with HM Government relating to the Government's review of Local Government Pension Schemes is ongoing, and they have been 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. In the meantime 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.

All London local authorities are being asked to respond to the proposal by 14 April 2014, or before the day of the local government elections (22 May 2014).

Recommendations

Both your Policy and Resources and Finance Committees have considered London Councils recommendations and commend them to you as follows:-

1. Note the work being undertaken to establish a collective investment vehicle, in the form of an authorised contractual scheme (the “ACS”), and the incorporation of a private company limited by shares, to act as the Authorised Contractual Scheme Operator (the “ACS Operator”), for local authority pensions in London (“the Arrangements”);
2. Endorse the establishment of a London Local Government Pensions Scheme Collective Investment Vehicle to be structured and governed as outlined in this report;
3. Agree to become a shareholder in the ACS Operator, and to contribute £1 to the ACS Operator as initial capital;
4. The appointment of the Chairman of Policy and Resources Committee as the elected member who will have power to act for the City Corporation in exercising its rights as a shareholder of the ACS Operator;
5. The appointment of the Chairman of the Financial Investments Board to act as the nominate deputy in this shareholder capacity.
6. Agree that the Chamberlain be appointed as one of the interim Directors of the ACS Operator;
7. Agree that a representative body, in the form of a new sectoral joint committee (the “Pensions CIV Joint Committee”), is established pursuant to the existing London Councils Joint Agreement to act as a representative body for those local authorities that resolve to participate in the Arrangements; and
8. Agree that, in the event that all local authorities resolve to participate in the Arrangements, that the Leaders Committee will undertake the role described as being for the Joint Committee.

Main Report

Background

9. 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). Following discussion, 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). At its 11th 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.

10. 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 Corporation and any decision would not be made until the autumn at the earliest.
11. The 33 London LGPS funds currently have over £20bn of assets under management. Previous reports have noted that some of those funds (including the City Corporation) 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.
12. 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.
13. The London Councils' work precedes this call for evidence. In 2012, a report from the consultants PwC 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 City Corporation was one of a number of authorities which, through the Financial Investments Board, agreed to contribute £25-£50k towards exploring the proposal, and a designated fund of these contributions has been established. These contributions will fund the professional costs associated with development of the proposed ACS and its Operator.
14. At its December 2013 meeting, the Leaders' Committee 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.

Financial Case

15. In considering the financial case, there are a number of areas being considered. Firstly the potential financial benefits of the ACS, and then the potential ongoing costs and costs of establishment. These benefits and costs are considered in more detail below, with a high level summary appended.

Financial benefits

16. The 33 London LGPS funds currently have over £20bn of assets under management. Previous work undertaken by PwC 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.
17. 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 10 to 20bps. There is no current information available about the level of return that is currently allocated to LGPS in relation to their existing investments.
18. Additional analysis of costs has been undertaken since the PwC report. The broad conclusion of this analysis is that, depending on the level of participation, the marginal costs for investing in the ACS are likely to be in the middle of the original 1 to 5 basis point estimate and that there are potential additional savings that could be made.

Custody costs

19. 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% (10 basis points) of assets under management. At around £6bn of assets, the custody costs would be in the region of 5 basis points. For assets in excess of £14bn, the costs are lower still, estimated to be 0.035% (3.5 basis points) of assets under management.
20. A reasonable minimum target size of assets 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.
21. At a level of assets of £5bn the additional custody costs would be expected to be in the range of 3 to 4 basis points (or £1.5 to £2m), being an ACS custody cost of

c.5 basis points less the 1 to 2 basis point charge which would have been incurred on existing investments.

Other costs and benefits

22. Other on-going costs of the ACS are likely to include staff costs, consultancy fees, FCA fees and administration costs including audit and taxation. These fees would be charged directly to the fund, as they would be now. Consultancy fees might include professional advice on investment manager selection and compliance with the 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. Admin costs would not be expected to be significant compared to the benefits identified.
23. 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.
24. 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.

Establishment costs

25. There will be a number of establishment costs incurred in setting up the ACS Operator and the ACS. These will be one-off costs in the first year.
26. £600,000 has already been contributed to these costs by the 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, it should be noted that the costs for working up 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.
27. As the project progresses, additional professional fees are likely to be incurred, for example to assist in training relevant individuals on their regulatory roles and to assist in the development of procedure manuals and assist in identifying key administrative functions which require to be outsourced, the service standards which should be required and negotiating this arrangement. It will become clearer in due course where costs may arise in this regard.
28. 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 clearly 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.

Proposed Structure

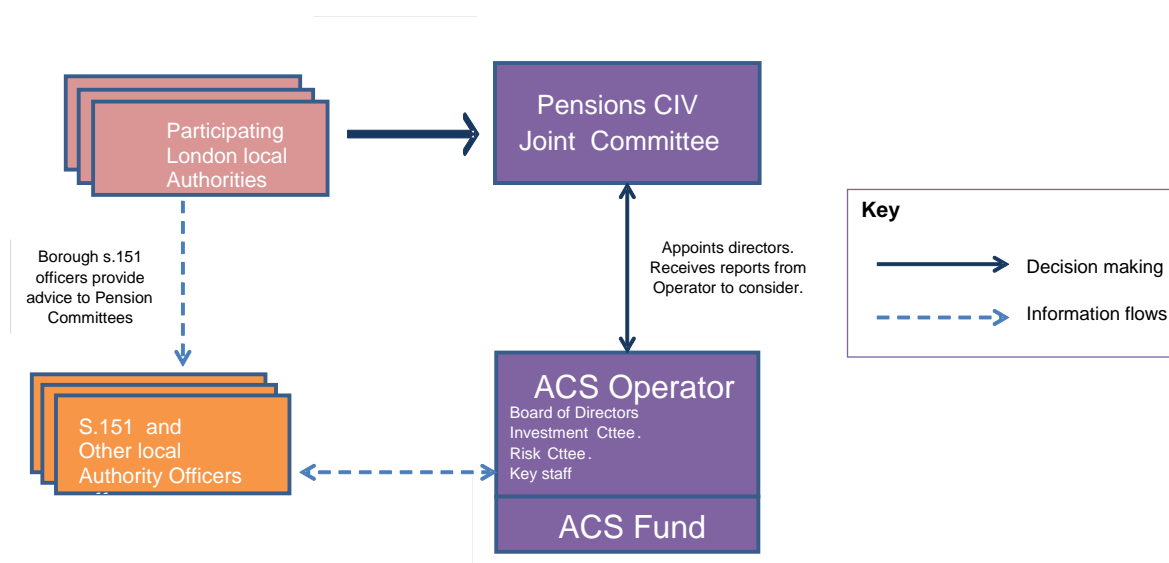
29. It was previously agreed that the most appropriate structure for the CIV is a UK based FCA authorised ACS fund, and nothing has emerged to suggest that that recommendation should change. During the ACS establishment process, some regulatory clarifications will be required although it is not currently 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.
30. 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.
31. 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.

Governance structure of the ACS Operator

32. 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.
33. 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 (in our case the Chairman of Policy and Resources) 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 relevant Borough Pension Committee could be appointed (in our case, at the present time this would be the Chairman of the Financial Investments Board).

34. 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 ongoing 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.
35. 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.



36. 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.

37. 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.
38. 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), myself (as 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).
39. With my impending retirement, it makes sense that the City Corporation agrees this in the name of the Chamberlain, rather than me personally. These are unremunerated positions.

Next Steps

40. 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 having £1 of share capital in the ACS Operator, and initial directors appointed, as set out above.

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.

Conclusion

41. London Councils has agreed to establish a collective investment vehicle, in the form of an authorised contractual scheme for local authority pensions in London. The City Corporation 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 who will have power to act for the City Corporation in exercising its rights as a shareholder of the ACS Operator, and to consent to the Chamberlain being appointed as an interim director of the ACS Operator.

42. 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).

All of which we submit to the judgement of this Honourable Court.

DATED this 20th day of February 2014.

SIGNED on behalf of the Committee.

MARK BOLEAT
Chairman of the Policy and Resources Committee

Appendix

The table attached sets out possible costs and savings at different levels of participation.

1.	2. Assets under management £24bn £ 000's	3. Assets under management £10bn £000's	4. Assets under management £5bn £ 000's
Expected gain ⁽¹⁾			
Investment management fees - 15 bps	36,000	15,000	7,500
Improved performance - 35 bps	84,000	35,000	17,500
Total expected savings	120,000	50,000	25,000
On-going Costs ⁽²⁾			
Custody costs - Custody costs (at 3.5bp, 4bp and 5bp)	(8,400)	(4,000)	(2,500)
<i>Incurring in existing third party funds ⁽³⁾</i>	<u>3,600</u>	<u>1,500</u>	<u>750</u>
Net Custody Cost	(4,800)	(2,500)	(1,750)
Other Costs			
Salaries –e.g. COO/Admin	(400)	(400)	(400)
- Audit/advice	(200)	(150)	(100)
- Offices/expenses	(200)	(200)	(200)
- Misc. Advisory	(500)	(400)	(300)
- Total On-going Costs			
	(6,100)	(3,650)	(2,750)
Establishment costs ⁽²⁾⁽³⁾			
- Transition advisory including custody selection	(700)	(500)	(400)
Other misc. fund advisory	(500)	(500)	(400)
- Legal, regulatory, and financial advice (funded already)	(600)	(600)	(600)
Total Establishment Costs			
	(1,700)	(1,500)	(1,400)

Notes

- (1) These savings are as previously considered. They have been allocated on a straight-line basis for assets under management less than £24bn. This is an assumption made for simplicity and any real savings may well be less and will depend on types of mandate, asset mix, etc. There are also other potential areas where financial benefits may arise, such as increased income from activities such as stock lending, which have not been quantified within the above.
- (2) All costs (other than custody costs) are estimated on very high level assumptions and may not reflect final costs.
- (3) For “other costs” and “Establishment costs”, some of these expenses would be incurred in existing investments or on changes of manager/investment. No attempt has been made to estimate these existing costs to date.