Haringey Council

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| **Report for:** | Corporate Committee 20th March 2014 | **Item number** | |

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| **Title:** | Pension Fund: London Collective Investment Vehicle |

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| **Report authorised by :** | Assistant Director – Finance (CFO) |

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| **Lead Officer:** | George Bruce, Head of Finance – Treasury & Pensions<br>george.bruce@haringey.gov.uk<br>020 8489 3726 |

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| **Ward(s) affected:** N/A | **Report for** Key /Non Key Decision N/A |

## 1. Describe the issue under consideration

1.1 The Committee agreed at the September 2013 meeting to contribute up to £25,000 towards the costs of establishing a Collective Investment Vehicle ("CIV") for London LGPS that aimed to assume responsibility for the appointment of fund managers. The establishment of a CIV is designed to reduce investment management fees and also to improve performance for those funds that select active fund management. This report summarises progress in establishing the CIV.

## 2. Cabinet Member Introduction

2.1 Not applicable.

## 3. Recommendations

3.1 That the Committee note progress towards the establishment of a London Collective Investment Vehicle.

## 4. Other options considered

4.1 The Society of London Treasurers has considered a range of options for increased collaborate working in London to enhance the efficiency of individual London Funds. A report was commissioned from the accountancy firm PWC in 2012 to look at a range of options including business as usual to a full blown merger. The options set out were:

- Shared procurement – easy to implement, but relatively low impact and savings limited
- Shared procurement with fund manager oversight – relatively easy to implement, savings higher than option 1, but still not significant
- Collective Investment Funds – less easy to implement, but significant potential for cost savings, whilst at the same time enabling funds to maintain local governance of funds
- Scheme merger of London funds – whilst cost savings are high, this would be very difficult to implement and would have a major impact on local accountability and governance.
- Centralised administration – again cost savings would be high, but issues around accountability and governance.

5.2 Consideration of the options led to the decision to explore ways of working more closely together to develop a collective investment vehicle for pension funds in London to achieve benefits of scale, bringing cost savings, but maintaining local decision making, governance and accountability.

## 5. Background information

5.1 In recent years there have been a number of discussion papers supported by academic research that has intimated that the LGPS would be more efficient if it was operated as a smaller number of larger funds. It has been argued that those larger funds would have lower unit administration costs and have better investment returns.

5.2 The Government initiated in summer 2013 a Call for Evidence of the impact of different LGPS structures in London with ministers indicating that they believe the current structure was sub optimal. In response, London Councils have been discussing closer working arrangement that can achieve the fee savings and performance improvements sought by the Government, without merging individual funds. As yet there has been no Government announcement from the Call for Evidence.

5.3 Discussions across London at Leader and CFO level have concluded that a collective Investment Vehicle (“CIV”) that takes responsibility for the identification of fund managers and the negotiation of fees for London funds can achieve the above goals.

5.4 The Committee discussed their willingness to participate in a CIV at the September 2013 meeting and agreed (a) to support further investigations into the potential establishment of a London-wide Collective, and (b) approve expenditure of up to £25,000 as a contribution towards the legal and other related costs in connection with the possible establishment of the CIV. The approved expenditure on set up costs has been paid to London Councils.

5.5 The London Councils Leaders' Committee has approved the detailed business case for the CIV and a proposed governance structure. They have also approved that a London Local Government Pension Scheme (LGPS) CIV in the form of a UK based, Financial Conduct Authority (FCA) approved, Authorised Contractual Scheme (ACS) be set up.

5.6 At the present time each Council is being asked to approve, through its Cabinet, participation in the structure, investment of £1 in share capital and nomination of a member to sit on a joint committee designed to represent the Council's interest as shareholder. There is no commitment to contribute further share capital nor to invest any funds in the CIV. Decisions on whether to invest pension assets in the CIV will be matters for the Council as trustee and administering authority of the pension fund, to be decided at a date in the future. Cabinet approval is being sought only to establish the CIV structure in order that regulatory authority can be applied for to carry out the planned activities.

5.7 Initially the CIV is targeting assets of £5 billion, mainly passive equities. Over time, it is expected that actively managed mandates and investments into alternatives such as property and infrastructure assets may be added to the range of investments offered by the ACS.

5.8 The London Councils Leaders Report sets out the likely Governance structures and key principles. The principles include: investment in the CIV should be voluntary; ability to choose how much to invest in individual asset classes; boroughs should have sufficient control over the CIV Operator, who would provide regular information to participating boroughs; and Authorities seeking to invest in the CIV will also take a shareholding interest in the Operator (and have membership of the Pensions CIV Joint Committee). This Joint Committee will be established under the existing London Councils arrangements to represent the participating borough's shareholder interest, such as assisting in the appointment of directors to the CIV Operator. The Pensions CIV Joint Committee will comprise elected Councillors nominated by participating boroughs as provided for under

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the existing London Councils Governing Agreement. The London Council's report proposes that in the event that all 33 boroughs decide to join then the existing London Councils Leaders Committee can undertake the role of the joint committee.

5.9 In that event that all boroughs do not participate it is nevertheless recognised that typically the borough Leader might be appointed as the representative on the joint committee. However, for meetings that deal with specialist matters, it may be appropriate that a member with particular expertise e.g. Chair of the Pensions Committee would act as deputy and attend such meeting.

5.10 As mentioned above, the setting up of the CIV is an executive function for Cabinet to determine. However, the Committee should be comfortable with progress and their eventual willingness to consider participation.

5.11 Attached to this paper for further information is a Q&A paper prepared by the London Councils. In the Q&A paper the CIV is referred to as an Authorised Contractual Scheme ("ACS"), which is the proposed legal structure.

## 6. Comments of the Chief Financial Officer and financial Implications

6.1. 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 from London Boroughs being prepared to commit funds to see the CIV established.

6.2. 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.

6.3 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 a £900 million pension fund and would clearly 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.

## 7. Assistant Director of Corporate Governance and Legal Implications

7.1 This report asks the Corporate Committee to note the progress on the establishment of a London Collective Investment Vehicle.

7.2 Cabinet will be asked to agree to the establishment of a company to operate the scheme, to contribute £1 initial share capital and to nominate an elected member to sit on the joint committee to represent the Council's shareholder interest.

7.3 There are no specific legal implications arising out of this report.

## 8. Equalities and Community Cohesion Comments

8.1 The Local Government Pension Scheme is a defined benefit open scheme enabling all employees of the Local Authority to participate. There are no impacts in terms of equality from the recommendations contained within this report.

## 9. Head of Procurement Comments

9.1 Not applicable

## 10. Policy Implications

10.1 The Coalition Government, since coming to power has undertaken a review of public sector pension schemes, leading to a number of major changes including changes to the benefits structures not only for the LGPS but also for Teachers, Civil Servants, Fire Brigades, etc. The objectives for reform are to maintain good quality pension schemes for those working in the public sector whilst looking to reduce the costs of the schemes including the administration of such schemes. Following on from this has been a 'Call for Evidence' from Communities and Local Government to consider the most appropriate structure for the LGPS going forwards. The Minister responsible for the LGPS, Brandon Lewis has made it very clear that he does not believe that the status quo is an option and has sought additional professional evidence to look at the potential costs and savings from a range of options which include merger of funds or collective investment vehicles. The outcome of the ‘Call for Evidence’ and a consultation on the future structure of the LGPS is expected over the coming months.

10.2 LGPS funds themselves have independently been looking at ways of reducing costs and working more collaboratively to bring about the benefits that can be achieved by closer working whilst ensuring that funds retain the local decision making and accountability.

## 11. Use of Appendices

11.1 Appendix 1 – Q&A

## 12. Local Government (Access to Information) Act 1985

12.1 Not applicable.

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**Appendix 2**

# London LGPS CIV Seminar
# 5th February 2014

## Summary of Questions and Answers

### Introduction

The s.151 officers and pension officers from many of the London Boroughs met on 5th February 2014, to discuss the Pension Working Group's report to Leaders' Committee on the progress of the project to develop a Collective Investment Vehicle (CIV). The session addressed a number of questions from officers, with the key area of discussion around governance issues. A summary is set out below.

### Aspects of the report

1. **Regarding the recommendations, should the decisions be made by local pension committees rather than at full council meetings?**

   [Deleted – out of date.]

2. **How many positive responses from boroughs are required to continue the project?**

   London Councils would require sufficient quantum and enthusiasm for the project in order to continue to act on behalf of the London boroughs collectively; however there is no set number of responses required.

   Nevertheless, we are mindful of the local elections, and how this may affect each borough's ability to reach decisions, and the position will be monitored over the coming weeks.

   For boroughs that cannot reach a decision now, the option to join later will always remain open.

   [**NB**. The positive response received to the report at the 11 February Leaders' Committee meeting makes it easier for London Councils to continue in its facilitation role.]

3. **How concrete is the proposed timeline for the launch of the ACS and ACS operator in order to take things forward?**

   The proposed timeline shows the possible time it may take to launch the ACS and the ACS Operator, and the work that needs to be completed. There is a minimum period of time that will be required to negotiate contracts and prepare FCA applications, and the amount of time the FCA may take to consider the application can vary (it is likely that the FCA will require 6 months to review the applications for the ACS and the ACS Operator although it cannot be guaranteed that both applications will be reviewed concurrently). As such, the timeline is only indicative, but based on previous experience it is a reasonable estimate.

4. **The report suggests £5bn of assets is a sensible target. If the £5bn threshold is not achieved what are the implications?**

   Analysis has suggested that £5bn of asset within the fund would be a sensible target to achieve the economies of scale which have previously been identified; however it is not a critical target size. If the fund size is smaller, the costs would increase per borough, as each borough would pick up a larger share, but this does not mean the costs would outweigh the benefits. Again, this will need to be monitored as the project progresses.

**The proposed structure**

5. **The report is brief on the benefits of the ACS itself. Why is the ACS vehicle considered most appropriate?**

   There are a number of advantages of using an ACS for the fund, including:

   - It is tax efficient e.g. for VAT there is an exemption on investment management fees, ensuring that VAT costs do not increase for the boroughs.
   - As the ACS is tax transparent, the withholding tax benefits the pension funds are currently entitled to can be maintained.

   It is also worth noting that the ACS structure was developed by HM Treasury, and launched last year, as an attractive alternative to other similar vehicles based in Ireland and Luxemburg. As such, they are very interested, and broadly supportive, of our proposals.

   The selection of an ACS as the most appropriate fund vehicle was set out in greater detail in a previous report to Leaders.

6. **Will the nominated interim directors have the required skills and qualifications to fulfil the role of directors in the ACS Operator?**

   One point to emphasise is that the interim board of directors is not intended to remain in place after FCA authorisation. It is temporary. It is there to steer the initial set up phases to assist in progressing the detailed work. The suggested interim directors are current Pensions Working Group members and have been involved in this project from an early stage.

The interim directors will be representing you and the company to facilitate it being established. Going forward new appointments will be made from candidates who are confirmed as suitable by the FCA. Selecting who these individuals may be, and deciding on the selection process, will be one of the tasks for the next phase of work.

**7. What are the risks associated with the ACS?**

This model is an authorised scheme by the FCA and so is heavily regulated. It is more highly regulated than similar funds in both Ireland and Luxembourg. As such, the risks are as if you were to make any normal investment. These risks include:

- Incorrect valuations
- Holding misrepresented on the register
- Fraud

These risks will exist in the fund. However there will be controls in place to mitigate these risks. This involves both legal clauses in contracts, and having the people with the correct skills, knowledge and expertise to manage the fund.

Regarding tax risk, the key tax risk is that the pension fund's investments are less tax efficient than they would have otherwise been. HMRC have provided assurances with regards to this vehicle to seek to provide comfort, for example, by confirming a VAT exemption on investment management fees.

**8. What measures have been taken to prevent the ACS going bust? What would happen to the assets?**

ACS operator is a limited liability company, in order to protect shareholders. It will have significant capital, which would mean that, although the ACS operator could be closed down if the participating boroughs chose to, it is very difficult for it to go bust. This is because the London boroughs will own the entity and so will control it as shareholders. The ACS will only have a maximum of 33 'clients' and so will be acutely client focussed in its approach.

The assets would be protected legally since they will be ring-fenced through the corporate entity, the ACS operator company. If the decision was made to close down the ACS the current value of the investments made would be returned to investors (subject to payment of any charges and any change in value caused by movement in the market).

The board of directors of the company will be responsible for monitoring the performance of the funds and so will receive detailed reporting on a regular basis. As boroughs are involved, there should be sufficient warning if it is felt the ACS is not providing value and boroughs wish to remove their funds.

If action was taken to wind up the ACS, it should be noted that the FCA will not allow the participants in the ACS to drop to a level where all the costs of closure would be borne by a few remaining participating councils in the vehicle. If any such action was taken significant redemptions would be managed to prevent few investors suffering the closure costs involved.

**9. What assurances can you provide that HM Government will not intervene?**

The risk of Government intervention must be taken into account, but London Councils have been maintaining active dialogue with the Department for Communities and Local Government. Nothing from this dialogue has given London Councils reason to believe that the current direction of travel will be stopped. London Councils believe the structure delivers much of what central Government are seeking to achieve. The Government are exploring the options for the reform of the LGPS, but it seems unlikely that any reforms will be mandated at this stage.

**10. How confident are we that the identified savings will be made?**

A very high level summary of the potential savings and costs have been provided in the report delivered to Leaders. The savings included here are based on work previously undertaken by PwC.

From some initial discussions in the market, it is considered that fund managers would be able to provide volume discounts due to the size of the fund.

As an example, analysis of data provided by the councils to Wandsworth showed that 7 councils use the services of the same fund manager, which has an ad valorum fee, with a total investment of c £750m. If those councils had pooled their assets through the ACS, then by not each having to pay higher fees on the first part of their investment, the overall fee saving would have been approximately £750k p.a. This is a simple example from the initial analysis, but indicates that savings that can be made through the ACS structure.

It was also noted that if the overall performance of the boroughs had been in line with the top performers, overall improved returns of close to £100m would have been achieved. Even if these mandates had been passive this could have resulted in a saving of £50m. These figures illustrate the potential benefit of a pooled approach, albeit future returns cannot be guaranteed.

**11. How will the CIV be better equipped at selecting the fund managers than the boroughs are now?**

There is of course no guarantee to this. However, the vehicle will have a core staff team looking after the fund, taking advice, and being able to spend more time on analysis on a full-time basis, and not as a smaller part of an existing and already busy day job, as can be the case now.

**12. How would mandates such as Infrastructure or Real Estate be governed? Is there a risk fund investments could be politicised?**

As a regulated company the ACS will require a robust governance structure that recognises the need for close engagement with its 'clients', whilst ensuring that its investment decision making is independent.

Any mandates for alternative assets will be considered by the ACS Operator, and discussed with the boroughs (as 'clients') in advance of being offered. As investors, each borough Pension Committee will be able to choose whether to invest in such mandates (and any such decision will need to comply with any investment restrictions applicable to a borough).

Similarly, if a number of councils wanted to make investments with a particular strategy, for example ethical investments, it may be that the ACS could offer this as one of the options should there be sufficient interest, but it would be for each borough to choose if this was one of the mandates it would invest in.

Currently, the Government cannot control the mandates of a regulated fund such as this. Therefore, they would need to change regulation if they wanted to do this.

[NB. An infrastructure fund 'think piece' will be developed in the coming weeks for discussion with the Pensions Working Group and boroughs.]

**13. Will boroughs need to go through a procurement exercise to invest in the ACS?**

If the scheme is kept to just the 33 London councils, then there should not be a need for individual boroughs to undertake procurement. Legal advice will be shared on this point. If the fund is offered more widely this will need to be considered further, but only in the context of the impact on those other local authorities seeking to join.

If boroughs wished to market test the ACS by undertaking a procurement exercise they would of course be able to.

**14. Is there a risk other investment managers would undercut the fees offered by the ACS in a procurement exercise?**

The ideal scenario is that the market will support the ACS and undercutting does not happen, although it would demonstrate further that better value has been driven by the existence of the CIV. It should also be noted that fees are not the only consideration when undertaking procurement. It is considered there is not a comparable offering in the market, where the mandates available have been so tailored to the needs of the London boroughs.

**15. If the government wants the structure to be adopted across the UK, what are the implications?**

A number of authorities are watching the developments here in London. In terms of this ACS, it may be that you choose (as owners) that other non-London LGPS funds can come in as investors, however they would not be shareholders of the Operator, and as such would not participate in decision making in the same way the participating London boroughs would.