HERTFORDSHIRE COUNTY COUNCIL

PENSIONS BOARD
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Agenda Item No:
2

LGPS INVESTMENT REFORM

Report of the Assistant Director, Finance

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1. Purpose

1.1 To provide members of the Pensions Committee with an update on the development of proposals for pooled investment vehicles for Local Government Pension Scheme (LGPS) Fund Assets, the development of pools nationally and the timescales for delivery of proposals to Government.

2. Summary

2.1 In the Summer Budget on the 7 July, the Chancellor announced that there would be a consultation on legislation for delivering savings via the use of pooled investment vehicles for LGPS fund assets.

2.2 The announcement stated that the government will work with LGPS scheme administering authorities to ensure that they pool investments to significantly reduce costs while maintaining overall investment performance.

2.3 The Chancellor signalled his consent to consult on the potential savings from pooled vehicles and that it would provide an opportunity for infrastructure investment.

2.4 The Government published its guidance at the end of November 2015 setting out its criteria for pooling proposals. Local LGPS Funds will be required to submit initial pooling proposals to the Government by 19 February 2016. The Government at the same time issued a consultation amending the current investment regulations which would see the removal of current prescribed investment limits. This is intended to relax the regulatory framework for the LGPS investments and to introduce safeguards to ensure that the less prescriptive approach is used appropriately, so called ‘Backstop intervention’ by the Secretary of State. The amendment of the investment regulations will facilitate greater investment in pooled vehicles and is also in response to authorities that the fund management industry calls for wider reform to de-regulate and allow LGPS funds more flexibility on investment decisions.

2.5 This report provides members with some further details of the criteria the Government has set out with regards to pooling and their expectations in terms of number of national pools (six) and infrastructure investment. Funds are required to submit initial proposals to Government in February stating where they are in the process of establishing/joining a pool. This is to provide Government with a sense of how pools are forming and along what lines. A more detailed submission is then required in July 2016. Each Fund will need to outline the pool they are going to join, how the governance of that pool will work, and outline the cost of transition and forecast savings for the next 15 years.

2.6 The Hertfordshire Fund has held exploratory conversations with two pools that have already been or are well on their way to establishing their investment vehicles; the London CIV and the LPFA/Lancashire partnership. Both of these pools have expressed an interest in working with Hertfordshire. Alongside this, the Hertfordshire Fund has been working with other East of England and South East Shire Counties in developing an evidence backed report to Government outlining its proposals for the pooling of assets, this report will be going to Government at the end of January 2016. This group, initially known as Project Pool, has now agreed to put together its own proposal to form a pool based on likeminded principles and the Hertfordshire Fund has also been invited to join this pool. This report sets out a high level view of these options and the steps to be undertaken to enable it to make a submission to Government by the July 2016 deadline.

3. Recommendations

3.1 That the Committee notes the content of this report including the independent review of pooling proposals to be considered at an additional meeting of the committee in March.

3.2 That the Pension Committee authorises the Chief Financial Officer, in consultation with Chairman of the Pensions Committee, to submit the finalised response on the Hertfordshire Pension Fund’s pooling options under consideration to the Government by February 2016. A copy of this submission will be circulated to members of both the Pension Committee and Pension Board.

3.3 That the Pension Committee authorises the Chief Financial Officer, in consultation with the Chairman of the Pensions Committee, to finalise the Hertfordshire response to the consultation on the Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. A copy of the response will be circulated to members of both the Pension Committee and Pension Board.

4. Background

4.1 The Local Government Pension Scheme (LGPS) had total assets of £178bn at the last valuation on 31 March 2013; it is one of the largest funded pension schemes in Europe. The scheme is managed through 90 administering authorities, including the London Pension Fund Authority (LPFA) and Environment Agency Pension Fund. Each administering authority has its own individual governance and working arrangements and different funding levels, cash-flows and balance of membership.

4.2 In 2013, the Coalition Government launched a call for evidence to explore how the Scheme might be more sustainable and affordable in the long term. Following this call for evidence, the Ministers for both the Cabinet Office and Local Government commissioned a cost-benefits analysis from Hymans Robertson on a range of proposals. The report from Hymans covered three areas:

1. The Cost of Investment;
2. Approaches to collaboration; and
3. The aggregate performance of the scheme

4.3 Drawing on the findings from the Hymans report, the Government published a consultation in May 2014 entitled “Opportunities for Collaboration, cost savings and efficiencies”. This set out how the Scheme could save up to £660m a year by using collective investment vehicles (CIVs) and making greater use of passive investment for listed securities such as equities and bonds. The consultation sought views on these proposals and how they could be implemented effectively.

4.4 After reflecting on the responses to the consultation, the Government announced its intention to invite administering authorities to put forward proposals for pooling local government pension scheme investments to deliver efficiencies from benefits of scale.

5. Investment Reform Criteria

5.1 In its guidance on Investment Reform, issued in November 2015, the DCLG set out the following four criteria for how administering authorities can deliver against the Government’s expectations of pooling assets.

1. **Asset pool(s) that achieve the benefits of scale**
2. **Strong Governance and decision making**
3. **Reduce costs and excellent value for money**
4. **An improved capacity to invest in infrastructure**

5.2 It will be for authorities to suggest how their pooling arrangements will be constituted and will operate. Appendix A explains further the criteria and detail that authorities will be required to describe in their submissions. Authorities are required to submit initial proposals to the Government by 19 February 2016. The proposals at this stage can be outlined reflecting the opportunities that pension funds are exploring.

5.3 This initial submission should include a commitment to pooling and a description of their progress towards formalising their arrangements with other authorities. Authorities can choose whether to make individual or joint submissions, or both, at this first stage. Refined and completed submissions are expected by 15 July 2016 which fully addresses the four criteria.

6. Pooling Options

6.1 In the guidance issued by the DCLG the Government encouraged authorities to learn from those who have already begun to develop collective investment vehicles (CIV), such as the London CIV or the Lancashire and the London Pensions Fund Authority proposal. The following provides some background to the pooling proposals put forward to the Hertfordshire Fund by the London CIV, the LPFA/Lancashire partnership, as well as a regional proposal from the East/South East of England Shire Counties known as Project ACCESS. On a national basis, Appendix B provides some detail on how other pools are forming and the potential size of these pools. For the Hertfordshire Fund there appears to be only three key options for consideration and they are the London CIV, the Lancashire/LPFA partnership or ACCESS, the regional pool.

6.2 London CIV

6.2.1 Of all the arrangements in development, the most advanced in establishing a pool is the London CIV which has received FCA approval and has already launched some of its Sub-Funds. The London CIV has been set up as a company; it is an FCA (Financial Conduct Authority) authorised contractual scheme fund and the London Boroughs are shareholders in this company.

6.2.2 Where there is commonality with the use of certain investment managers for particular assets classes by some of the London Borough Funds, then their assets will transition to the CIV if that manager has been selected as one of the investment managers to be used by the CIV. Where this has happened, the London CIV has been able to negotiate reduced fees through economies of scale. The Fund Managers will contract with the CIV rather than the underlying Boroughs, will manage the assets on a pooled or segregated basis for the CIV and will report to the CIV as a single entity.

6.2.3 The London CIV is keen to work with counties bordering London, their aspirational target size of assets under management is £50bn. Officers from the Hertfordshire Fund and the Chair of the Pensions Committee met with Hugh Grover, the CEO of the London CIV on the 13 January. Mr Grover explained the London CIV approach to pooling, providing details on the set up of the pool, regulatory compliance, how the governance of the pool works, the number of asset classes already implemented, as well as their future intentions. The Hertfordshire Fund would be a shareholder in this pool if it joined, whether this is equitable or determined by assets in the pool is to be confirmed. Appendix C illustrates the structure of the London CIV.

6.3 **LPFA and Lancashire County Council – Asset pooling and liability management partnership (ALM partnership structure).**

6.3.1 Lancashire and the LPFA are creating a structure to allow funds to pool assets to achieve economies of scale and to deploy tools and knowledge to better manage liabilities on a joint basis whilst retaining local accountability. Their aspiration is that this will provide a platform to encourage participation from other LGPS funds providing access to a wider set of investment and liability management opportunities. The ALM is slightly behind the London CIV in that it has not received all its FCA approvals yet but expects to receive this in the first quarter of 2016.

6.3.2 The ALM partnership would like to invite other funds to join them in their pool and offers an alternative to the London CIV in that we can have an equity holding in the arrangement which would provide access to all services, including administration and liability tools for managing employer and investment risk. Officers and the Chair of the Pension Committee of the Hertfordshire Fund met Sir Merrick Cockell, Chairman of the LPFA and Susan Martin, the CEO of the LPFA on 6 January 2016. The ALM partnership is different to the London CIV in that it has internal management and is not primarily reliant on external fund managers for investment. Appendix D illustrates the proposed governance structure of the ALM partnership.

6.4. Project ACCESS (A collection of Central, Eastern and Southern Shires) POOL.

6.4.1 This project is at inception stage and came together as a result of LGPS funds in the East and South East of England coming together to discuss asset pooling options and to produce a joint evidence backed report for government proposing pooling options for various asset classes. The work undertaken by this group has been facilitated by Hymans Robertson but the report and work is owned by the group of LGPS funds. The Hertfordshire Fund has been an integral part of this project exploring the various pooling options and contributing to the writing of this report.

6.4.2 The purpose of this report is to provide government with a joined up response from local authorities who run LGPS funds, setting out proposals which are sufficiently ambitious and will achieve government objectives in a way that also meets the needs of those who administer and manage the LGPS on behalf of all its many millions of scheme members.

6.4.3 This report has been prepared by local authorities' officers from participating funds who have collaborated initially under the banner of Project POOL, supported by Hymans Robertson. Project POOL set out with three goals;

1. to produce an evidence based and objective analysis of pooling options
2. to enable LGPS stakeholders to gather round one or a small number of options which satisfy the Government's criteria

3. to form a basis of discussion between the LGPS and Government on the best way forward

6.4.4 There is broad consensus on the conclusions drawn from this work and the proposals set out in this report amongst the diverse group of funds who have committed time and effort to collaborate on it. This report has now been published.

6.4.5 The main findings from this project is that the preferred pooling option would be multi-asset pools (MAPs), similar to the London CIV model, formed by regional and/or like-minded groups of funds. For particular assets, the group consensus was that greater benefits may be available by wider LGPS collaboration; infrastructure being a clear example where a national infrastructure pool would deliver scale and savings, addressing one of the Government's criteria. It was also agreed that the national procurement frameworks that have been set up and already deliver savings continue to be used as part of the wider approach to LGPS collaboration.

6.4.6 The ACCESS project group now intend to move from preliminary discussions to delivering a firm proposal to form a multi-asset pool of like-minded Funds in response to the Governments reform programme. Project ACCESS intend to make a joint submission to the Government criteria in February and will then take this forward to produce a detailed joint proposal for July.

6.4.7 The following Funds have signalled their intention to work with the ACCESS group to establish a collaborative and fair governance structure for the pool engaging Members and Officers, which will be sustainable for the very long term:

Cambridgeshire
Essex
Kent
Isle of Wight
Norfolk
Northamptonshire
Suffolk
West Sussex

6.4.8 Whilst Hertfordshire is yet to determine its approach to pooling, we have to date been an integral part of the project ACCESS team and this group would like the Hertfordshire Fund to join them in developing a joint pooling proposal to Government. The group has shared pension data and a summary of the findings from that data sharing is contained in appendix E. The following synergies could be obtained in working with the above group in developing a pool such as:

- Geographic location – most of the funds are in the East or South East of England;
- Assets under management would be circa. £25bn;

- The named funds use similar external consultants such as investment advisers and actuaries as well as investment managers;
- Most of the funds use external managers with a small proportion using internal management;
- Regional relationships already exist at both member and officer level with a number of the named authorities and this could be viewed as a further logical development of these relationships; and
- Governance would be less unwieldly compared to the London CIV as there would be a fewer number of funds in the pool.

6.5. Other Pools

There are a number of other pools being discussed and developed but all are in a state of early fruition, appendix B provides some further details of these pools, geographic location, size and governance. The map illustrates that the majority of these pools and participants are geographically co-located, with the exception of one or two pools. The Government through discussions that LGPS funds and consultants have held with the Cabinet Office, DCLG and the Treasury have indicated that they would like to see six regional based funds to emerge with assets under management of £25bn. The current number of proposals in scope would exceed this number.

6.6 Infrastruture

6.6.1 The Government would like to see in the proposals put forward by the pools how, through the creation of up to six pools, it might facilitate greater investment in infrastructure. Authorities will need to explain when developing proposals the following:

- The proportion of their fund allocated to infrastructure, both directly and through fund, or "fund of funds".
- How they might develop capacity and capability to assess infrastructure projects and reduce cost by investing directly in this asset class through pools rather than fund or "fund of funds".
- The proportion of their fund they intend to invest in infrastructure, and their ambition going forward.

6.6.2 A consensus seems to be forming within LGPS funds that a joint infrastructure vehicle would be the way for pools/funds to access infrastructure investment and the purpose of this vehicle will be to identify, assess and provide access to national and international infrastructure opportunities which meet pre-agreed criteria that match the investment needs of the Scheme. The findings from Project POOL also support this argument in that a national pool is the proposed solution for investment to this asset class. The Local Government Association (LGA) are forming a joint officer group to develop detailed proposals for the creation, structure, governance and operation of an infrastructure vehicle for agreement by fund authorities and submission to Government in time to meet the July deadline.

7. Next Steps: Addressing the Criteria - Requirements and Timetable

7.1 Authorities are required to submit initial proposals by the 19 February 2016; these proposals should include the following:

- A commitment to pooling; and
- Progress to date in formalising arrangements with other authorities

At this stage we will need to respond to DCLG on our progress to date and confirm our commitment to pooling.

7.2 The second stage requires detailed submissions addressing the four criteria in section 3, and these are expected by 15 July 2016. The submitted detail at this second stage should include:

1. For each pool, a joint proposal setting out pooling arrangements in detail to include governance structure, decision making process and timetable of implementation; and
2. Each authority must also submit an individual return detailing the authority's commitment to, and expectations of the pool. This should also include a profile of costs and savings, transition profile of assets and rationale for holding assets outside the pool.

7.3 A draft of the submission would need to be provided to the Pensions Committee and Pension Board at their meetings in June respectively. The deadlines for submission of pooling plans are extremely tight given the work and collaboration that will need to be undertaken in this period to pull submissions together.

7.4 The key criteria in supporting the final decision by the Hertfordshire Pension Fund will include, where we have 'like-minded' interests, whether the proposal addresses the Government criteria, and the governance model provides equitable voting rights, and deliver synergies and savings from the merger of assets.

7.5 The Government will assess each proposal, issue a brief report in response setting out how each proposal meets the criteria, highlight areas which fall outside the criteria and request any additional evidence it may require. If any LGPS funds don't submit proposals, then they will, through the reform of the LGPS investment regulations, be forced by Secretary of State Powers of intervention to join a pool.

7.6 Given the scale of work and extremely tight timescales, officers, in consultation with the Chair of the Pensions Committee, have commissioned Mercer to review the pooling proposals received from the three parties referred to in this paper. It is proposed that a report is produced to outline how each proposal meets (1.) the Government Criteria and (2.) meets the interests and needs of the Hertfordshire Fund. This report will be submitted to a special Pension Committee to be held in March, to enable the Pension Committee to decide its preferred choice for pooling. This will be subject to final approval by the County Council at its meeting in May 2016. Table 1 below provides an investment pooling timeline of future decisions.

Meeting/Deadline	Date	Detail/Decision
Project Access pool	2^{nd} February 2016, London	Meeting of elected Pension Committee Chairs and lead officers
Pension Committee	5^{th} February	Pooling paper – recommendations for review of options by Mercer.
Initial Pooling Submission to DCLG	19^{th} February	Submission to include a commitment to pooling, progress towards formalising arrangements with other authorities.
Pension Committee	February/March tbc	Agreement on final pool option following Mercer review for recommendation to Council.
Council	17^{th} May 2016	Council approve Pension Committee Recommendation
Pension Committee	10^{th} June 2016	Review of final individual pool submission to DCLG.
Final Pooling Submission to DCLG	15^{th} July 2016	Submission to include: (1.) joint proposal setting out the pooling arrangement in detail, for example the governance structures, decision-making processes and implementation timetable. (2.) Individual returns detailing profile of costs and savings and transition of assets to pool.

8. Transitional arrangements to pools

8.1 In the guidance the Government has said that it expects that transition plans should be made to transfer assets as soon as practical. It has been suggested through analysis commissioned by the Government that pooling vehicles could be set up within 18 months. There is an expectation that liquid assets such as traded equities are transferred into the pools over a short time frame from April 2018. Liquid assets will transition over a longer period of time and high exit costs should be avoided to ensure value for money.

8.2 The guidance states that during the development of pools, authorities should continue to manage their investment strategies and hold performance review meetings with their investment managers.

9. Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009

9.1 Alongside the pooling criteria the Government issued a consultation on the reform of the investment regulations for the management and investment of LGPS funds. The reform of these regulations will remove a number of prescribed limits and will allow more freedoms for investment. Reform will enable the creation of pools but will also introduce Secretary of State powers of intervention where it is felt that LGPS funds are not complying with regulations or guidance. Funds are invited to comment on the proposed changes by 19 February.

9.2 As part of this deregulation, the draft regulations propose that each authority will be required to produce an investment strategy statement. This will replace the existing Statement of Investment Principles (SIP), having taken proper advice, and publish this statement. The statement must cover a number of areas including:

- A requirement to use a wide variety of investments.
- An assessment of the suitability of particular investments and types of investment.
- The Fund’s approach to risk, how it’s measured and managed.
- The Fund’s approach to collaborative investment.
- The Fund’s environmental, social, and corporate governance policy.
- The Fund’s policy on the exercise of rights, including voting rights, attached to its investments.

9.3 Subject to any changes to the draft regulations following the consultation period, it is expected that the new investment regulations will come into force with effect from the 1 April 2016. Authorities are expected to have in place their new investment strategy by no later than 6 months after the new regulations have been introduced, for example the 1 October 2016. The table below sets out a suggested timetable for the delivery of the new investment strategy.

Table 2: Investment Strategy (IS) Review Timetable

Meeting/Deadline	Date	Detail/Decision
Pension Committee	10th June 2016	Draft IS for review
Pension Board	17th June 2016	Draft IS for review/comment
Joint PC/PB workshop	Tbc	Principles of developing an IS and setting risk and return objectives
Pension Committee	9th September 2016	Approve final IS
Pension Board	30th September 2016	Review final IS
Investment Strategy	1st October 2016	New IS in place

Background links:
https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies

https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance

https://www.gov.uk/government/consultations/revoking-and-replacing-the-local-government-pension-scheme

Appendix A: Investment Reform Criteria

Criteria

A. **Asset pool(s) that achieve the benefits of scale:** The 90 administering authorities should collaborate to establish and invest through asset pools each with **£25bn** of Scheme assets. The proposals should explain:

   - The size of their pool(s) once fully operational.
   - Any assets they propose to hold outside the pool(s) and the rationale for doing so.
   - Type of pool(s) they are participating in, including legal structure if relevant.
   - How the pool will operate, work to be carried out internally and services to be hired from outside.
   - Timetable for establishing the pool(s) and moving their assets into the pool(s). Need to report transparently progress against timetable.

B. **Strong Governance and decision making:** The proposed governance structure for the pools should:

   I. At the local level, provide authorities with assurance that investments are being managed appropriately by the pool in line with their investment strategy and long term interest of members;
   II. At the pool level, ensure that risk is adequately assessed and managed.

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   In their submissions, Authorities will need to explain the internal governance of the pool to include the following:

   - The governance structure for the pool to include accountability between elected members and the pool, and how external scrutiny will be used;
   - How this Authority will hold the pool to account and ensure that 1.) Its investment strategy is implemented effectively, and 2.) its investments are being well managed;
   - How decisions are made at each stage;
   - Shared objectives of pool;
   - Resources allocated to manger pool;
   - How environmental, social and corporate governance policies will be manged by the pool;
   - How net performance of each asset class will be reported publically; and
   - How benchmarking will be used by each authority to assess their own governance and performance and that of the pool.

C. **Reduce costs and excellent value for money:** Authorities will need to explain all costs associated with investment management and proposals should explain how the pool(s) will deliver substantial savings in investment fees, both in the near term and over the next 15 years whilst maintaining overall investment performance. As part of their proposal, authorities are required to provide:

- A fully transparent assessment of investment costs and fees as at 31 March 2013;
- A fully transparent assessment of current investment costs prepared on the same basis as 2013;
- A detailed estimate of savings over the next 15 years;
- A detailed estimate of pool implementation cost and when they will arise and how they will be met; and
- A proposal for reporting transparently against forecast implementation and transition costs.

D. **An improved capacity to invest in infrastructure:** The pooling of assets is expected to facilitate greater investment in infrastructure and authorities are invited to explain how this will feature in authorities investment strategies and how pooling can improve the capacity and capability to invest in this asset class.