

Pensions CIV Sectoral Joint Committee

Item no: 4

Potential changes to the LGPS

Report by: Hugh Grover **Job title:** Chief Executive, London LGPS CIV Ltd.

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Contact Officer:

Telephone: 020 7934 9942 **Email:** hugh.grover@londoncouncils.gov.uk

Summary

This report informs Committee members of potential changes that could affect the LGPS. The changes being

- i. The Chancellors Budget Update/Conservative Conference Speech;
- ii. Separation of the Pension Fund from the Host Authority; and
- iii. The impact of Markets in Financial Instruments Directive (MiFID II) and its implementation in the UK.

To provide additional clarity and facilitate detailed discussion officials from the Financial Conduct Authority, HM Treasury and the Department for Communities and Local Government are expected to attend the meeting for this item.

Recommendations

The committee is recommended to:

- i. Consider the issues raised in this report; and
 - ii. Take the opportunity presented by the attendance of the FCA, HM Treasury and DCLG to discuss the issues with officials.
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Potential changes to the LGPS

Introduction

1. There are three areas of potential change for the LGPS that are being considered by the government and its advisors at this time:
 - i. **Reform to the structure of the LGPS** to deliver greater collaboration in the area of investment, with the aim of delivering significant costs savings through greater efficiency;
 - ii. A proposal being considered by the Scheme Advisory Board looking at **separating the Pension Fund from the Host Authority**; and
 - iii. The implementation of the latest iteration of the Markets in Financial Instruments Directive from the EU (**MiFID II**).
2. The first of these has been discussed by the Committee at a number of its meetings, most recently at the last meeting (21 July 2015), the other two have not been to this Committee before but are considered to be of sufficient importance that Members may wish to have a collective discussion about the implications and to steer officers as to the actions that London Councils may take on behalf of its members.
3. This report now covers each issue in turn.
4. when it was noted that the 2015 Budget contained the following statement:

Reform to the structure of the LGPS

5. The Committee will be aware that the debate about potential reform to the structure of the LGPS has been ongoing for several years. In 2012 and 2013 the government made a number of announcements about how they thought the LGPS might be restructured and these were followed by a call for evidence that ran during the summer of 2013 and a subsequent consultation that was published in May 2014. No government response to the 2014 consultation has been published and no further official announcement had been made until the 2015 Budget which contained the following statement announcing potentially far reaching changes to the degree and flexibility that will be given to Funds in the future regarding local decision making and control in the management and allocation of LGPS pension fund investment assets:

“The government will work with Local Government Pension Scheme administering authorities to ensure that they pool investments to significantly reduce costs, while maintaining overall investment performance. The government will invite local authorities to come forward with their own proposals to meet common criteria for delivering savings. A consultation to be published later this year will set out those detailed criteria as well as backstop legislation which will ensure that those administering authorities that do not come forward with sufficiently ambitious proposals are required to pool investments.” [Page 78, para 2.19]

6. It is noteworthy that the statement makes no mention of the debate concerning active versus passive investment, a mandatory passive approach or any prescriptive legislation involving passive investment at this time.

7. The Budget statement was further reinforced by the Chancellor in his speech to the Conservative Party conference when he said:

“...Second, we are going to find new ways to fund the British infrastructure that drives our productivity. At the moment, we have 89 different local government pension funds with 89 sets of fees and costs. It’s expensive and they invest little or nothing in our infrastructure. So I can tell you today we’re going to work with councils to create instead half a dozen British Wealth Funds spread across the country. It will save hundreds of millions in costs, and crucially they’ll invest billions in the infrastructure of their regions.”

8. This is a clear signal that there is a strong desire across government for the LGPS to invest more of its assets in UK infrastructure and the belief that collective investment may have the potential to unlock that investment.

9. The Chancellor also acknowledged Labour's role in proposing a National Infrastructure Commission, saying he was "delighted" Lord Adonis, policy chief in Tony Blair's government before becoming transport secretary under Gordon Brown, had agreed to lead it.

10. Officials of the London CIV have continued to be in close contact with government officials about the implications for London LGPS funds and the London CIV initiative. Informal reassurance has been given that the CIV is an acceptable response to the statements and direction of travel that the government wishes to see – subject of course to formal Ministerial decisions that will be taken in the early months of 2016.

11. Looking in detail at the Budget statement a number of areas of detail are apparent, each of which raises a number of potential questions:

- “...significantly reduce costs...”
 - Does this apply across the LGPS, or for those Funds that are considered to be expensive or poor performing?
 - Will a benchmark be set by Government?
- “...maintaining overall investment performance.”
 - Is this measured at the LGPS Fund average, or is it the aim to drive the lower performing funds to achieve above average performance?
 - What consideration is to be given to individual funding levels and risk profile?
 - Over what periods will the assessment be made?

[NB. It should be remembered that, by definition, not all funds will ever achieve the average performance.]

- “...will invite local authorities to come forward with their own proposals to meet common criteria...”
 - How long are Funds to be given to develop these proposals?
 - What are these common criteria and how will they be used?
 - Will the common criteria be subject to consultation?
 - How far advanced do a Fund's proposals need to be?

- With regard to “common criteria”, will these include total pooled fund asset values, or will there be a basket of measures such as the key performance indicators (KPIs) currently being developed by the LGPS Scheme Advisory Board (SAB)?
- “...backstop legislation which will ensure that those administering authorities that do not come forward with sufficiently ambitious proposals are required to pool investments.”
 - How ambitious is ‘sufficiently ambitious’?
 - How will the ambition be measured?
 - What will the legislation be and what is the implementation timescale?
 - Will this mean that only those funds that do not meet the criteria have to pool, or will it go further to announce that, in addition to pooling all funds, funds will be required to allocate certain proportions of assets to specific investment strategies and asset classes (passive management or allocations to UK infrastructure)?

12. The forthcoming consultation will set out a timeline which is expected to be along the lines set out below:

Government to commission and receive independent advice from “industry experts” to help set the “common criteria	Oct 2015
Consultation and the backstop enforcement regulations published	Early Nov 2015
Consultation response from all stakeholders (expectation is for 12-week response period)	Early Feb 2016
Draft Regulations published	March 2016
Effective date	April 2016
Creation of asset pools (phased in over three years)	April 2019
Transition of assets for those funds not meeting the ‘common criteria’	Unknown

13. The November Consultation is expected to include:

- Legislative changes circulated in draft to give the Secretary of State increased powers;
- Proposed changes in the investment regulations;
- Acceptable criteria for pooling;

- Back stop measures for recalcitrant schemes.
14. There are no plans to formally consult on the criteria for pooling. It is thought that the criteria for pooling (all asset classes) are likely to cover:
 - Scale (£25-£30bn target);
 - Cost Savings;
 - Governance.
 15. In addition, it is anticipated that there will be a further statement in the Chancellor's 2016 Budget. The Government acknowledges that pooling will take at least three years, with some assets (Private Equity, etc.) taking longer. The consultation paper will outline 'common criteria' that will be used to assess the proposals brought forward by Funds, including the optimal scale and size of pooled investments and the role of passive management in a Fund's investment strategy.
 16. The focus is now described to have changed from active/passive to an issue of scale and better governance. The government is not wedded to one type of pooling or another. They are not expected to be prescriptive, preferring to hear proposals direct from the LGPS. Overall scale has strong political appeal with the ultimate model being one in which strategic asset allocation is set locally by each Administrative Authority, with that allocation being implemented by investing through asset pools.
 17. The Chancellor's announcement makes clear that government is targeting investment fee savings on the current annual LGPS £660m fee base (as identified in the original Hymans Robertson report). As such, the industry assumption is that a slice away from this fee base is the minimum benchmark upon which any proposals involving asset pooling will be measured. It has been acknowledged that, as well as cost savings, the maintenance of existing overall investment performance is necessary.
 18. To date, it is still unclear whether this performance is to be measured at the average national level or individual fund level. The distinction is critical to top performing Funds who would not wish to see their performance being pulled down to the average. It should be noted that the achievement of a 100% funding level within a specific timeframe is not amongst the Government's objectives being targeted.

Separation of the Host Authority from the Pension Fund

19. Whilst the LGPS in England and Wales is one scheme, it is comprised of 89 different administering authorities. The size of the funds varies widely, as do the arrangements for its management. In some instances, pensions operations are integrated within the HR and Finance functions of the relevant administering authority; in others, discrete pensions units have been created to take on the task.
20. In practice decisions about pensions are delegated by the Administering Authority in accordance with Section 101 of the 1972 Act to:
 - Committees or sub-committees made up of councillors from all the political groups and will be politically balanced; or
 - Officers.

21. The delegation of pension functions varies from Administering Authority to Administering Authority depending on local circumstances. The Regulations require an Administering Authority's governance compliance statement to set out whether the Authority delegates its functions and the detail of the delegation given. In addition there are specific legal requirements (as well as precedent through case law and statutory guidance) for the Section 151 officer or the Chief Financial Officer relating to the LGPS.
22. Each Administering Authority (as defined in Part 1 of Schedule 3 of the LGPS Regulations 2013) is responsible for managing and administering the LGPS in relation to any person for which it is the appropriate administering authority under the Regulations. The Administering Authority is responsible for maintaining and investing its own Fund for the LGPS.
23. The majority of Administering Authorities are local authorities and therefore operate in accordance with local government law. However, some Administering Authorities are not local authorities such as the Environment Agency, the London Pensions Fund Authority and the South Yorkshire Pensions Authority. Such bodies operate in accordance with their own legal constitutions.
24. There are diverse approaches to how each LGPS Fund operates. In some instances, two or more Administering Authorities may share their administration function, for example through a shared service arrangement, or in other ways. However, where this happens each local authority still retains its own individual Administering Authority status and therefore legal responsibility for its own Fund.
25. The options being considered by the Scheme Advisory Board and set out below, each seek to improve the governance of pension funds by increasing the degree of separation between the scheme manager function (the management and administration of the scheme and the local fund) and the host authority:
 - **Option One:** Stronger role for a separate Section 151 Officer within a distinct entity of the LA, Separation of financial statements and audit arrangements. Pension fund-specific annual governance statement. Specific delegations that require a senior officer to lead the function. Group the responsibility for all LGPS related activities within one function.
 - Under this option each host authority would be required to group all LGPS related activities within one discrete organisational unit. Currently the arrangement of how LGPS activities are managed is determined by individual administering authorities.
 - **Option Two:** Joint Committee of two or more administering authorities. Delegation of full scheme manager function and all decision making to a section 102(5) joint committee. Employment of staff and contractual issues dealt with through lead authority or wholly owned company. Ownership of assets unchanged. Consideration be given to enshrining the structure in legislation in the form of a combined authority.
 - Under this option each of the LGPS administering authorities involved would delegate the function of scheme manager in its entirety to a joint committee under Section 102(5) of the Local Government Act 1972 (Part 2 paragraph 5). The joint committee will then be responsible for all decisions relating to the management and administration of the scheme including asset allocation,

manager selection, administering authority discretions, provision of administration services, appointment of advisors and procurement of related services (e.g. actuarial, legal and custodial). The constitution of the joint committee would need to be contained in a formal agreement entered into by the authorities. The joint committee as constituted would not be a separate legal entity therefore it cannot own assets, have liabilities, raise taxes, enter into contracts or employ staff. The ownership of assets (administering authority) and responsibility for meeting liabilities (employers) would not change. Employment of staff, entering into contacts and other operational matters would be delivered via a lead authority using a LG Act 1972 Section 113 agreement or an arrangement under the Good and Services Act 1970. Alternatively the authorities could create a jointly owned and controlled company to perform this function.

- **Option Three:** Complete separation of the pension fund from the host authority. DCLG or Treasury to create single purpose Pensions Bodies. Remove decision making from elected members. This option seeks to remove the potential for conflict of interest between the host authority (sponsor) and the pension fund (institution) by removing the fund and placing it in a separate body with its own duties and interests that are solely aligned with those of the beneficiaries. Elected members of a current host authority may well be on the board of the new body but as employer representatives with no more or less say in the direction of investment policy than any other board member.
 - The option aims to remove any possibility of the host authority from taking decisions on investments which prefer its interests over the interests of the members of the LGPS or other employers in the fund.

26. KPMG have been appointed by the Scheme Advisory Board (SAB) to look into the above three options and come up with their findings, summarised as follows:

- **Option One:** Ring fencing of a new S151 officer for the Pension Fund - but conflicted to an extent as this officer will still be part of the Local Authority (same CEO). However, this can be managed through clear guidance, investment strategies, and separate audit opinion for the Pension Fund. A separate SLA and AGS will be needed. To facilitate this, changes to legislation will be needed i.e. CIPFA (cost accounting), Secondary (separate audit opinion). The anticipated cost is between £100-150k.
- **Option Two:** Joint Committees - There are some serious questions to be asked under this option a) how many funds to be serviced? Three, four, ten members! Size becomes an issue. b) Investment strategy - dictatorship no separate investment strategy. So more work needs to be done. However, there are fewer conflicts of interest as the Joint Committee will be separate to that of the participating Local Authorities. It needs to be a standalone body. Engagement with employers becomes more of an issue due to resourcing issues. The anticipated costs are at £300k.
- **Option Three:** Full separation from the Local Authority and the Pension Fund – The question around the Crown Guarantee and if it will still be a LGPS Fund becomes a major question/issue that needs to be answered. However, this is the only option where there is clear separation between the Fund and Local Authority; this therefore

leads to better transparency. This option is very much private sector so best practice to an extent will be followed, but we can still do this in option one. Further legislation will be needed. More set-up costs £300k set up, plus additional resourcing £500k.

27. It is important to note, that KPMG have not been asked to come up with a recommendation and no timeline has been given in relation to when this is to be brought in.

MiFID II

28. MiFID II is the European Union's second Markets in Financial Instruments Directive. There many stories about poor investment decisions by local authorities across Europe and the new legislation seeks to 'protect' such authorities from riskier investment options available in the markets by reclassify all local authorities to 'Retail' clients from their current 'Professional' status.

29. This would mean that all financial services firms like banks, brokers, advisers and fund managers will have to treat local authorities in the same as they do individuals and small businesses. That includes ensuring that investment products are suitable for the customer's needs (potentially closing the option for the LGPS to invest in certain products), and that all the risks and features have been fully explained. This involves significantly more paperwork for both the firm and the client, to prove to the regulator that all the steps have been taken, and as evidence in case of alleged mis-selling.

30. MiFID includes an option for certain retail clients to opt for professional status ("Elective Professional Client" status). To achieve this a local authority will have to meet the following two criteria as set out in COBS 3.5.3 of the FCA Handbook (<https://www.handbook.fca.org.uk/handbook/COBS/3/5.html>):

- "(1) the firm undertakes an adequate assessment of the expertise, experience and knowledge of the client that gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved (the "qualitative test");
- (2) in relation to MiFID or equivalent third country business in the course of that assessment, at least two of the following criteria are satisfied:
 - (a) the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters;
 - (b) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds EUR 500,000;
 - (c) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged;(the "quantitative test");

31. In most cases it would seem likely that a local authority would be eligible to 'elect up', but this should not be taken as automatic, each individual fund manager (of which the London CIV would be one) would have to take the necessary steps to be reassured that the 'client' fully qualifies for elective professional status.

32. MiFID II will be implemented from January 2017.

33. It may be that existing arrangements with fund managers could continue under the “grandfathering” rules, with current service providers continuing to treat authorities as professional clients. However, even if this is possible, new business relationships after January 2017 will fall under the gamut of MiFID II.

34.

Recommendations

35. The committee is recommended to:

- i. Consider the issues raised in this report; and
- ii. Take the opportunity presented by the attendance of the FCA, HM Treasury and DCLG to discuss the issues with officials.

Financial implications

36. There are no financial implications for London Councils.

Legal implications

37. There are no legal implications for London Councils.

Equalities implications

38. There are no equalities implications for London Councils.