

# Pensions CIV Sectoral Joint Committee Item no: 9

## Passive Funds Fee Proposal

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**Summary:** In 2015 and 2016, London CIV was instrumental in negotiating a substantial reduction of management fees across the London Local Authority (LLA) passive assets managed by Legal and General (LGEM)

London CIV was asked to consider options for charging a fee to London Local Authorities (LLAs) on passive funds held outside of LCIV which have benefitted from LCIV fee negotiation efforts.

This report informs Committee members on the negotiations background, passive fee options and LCIVs proposal for the fee structure and fee level to be implemented as of 1<sup>st</sup> April 2017.

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**Recommendations:** The committee is recommended to:

- (i) Agree an AUM based fee to be charged to the LLAs benefitting from reduced fees negotiated by LCIV on any passive funds managed outside of LCIV;
- (ii) Consider the fee level options in Annex B and agree preferred fee scale to be charged; and
- (iii) Agree date of 1<sup>st</sup> April 2017 for implementation of passive fee charges to commence and a review of the fees after five years.
- (iv) Agree that LLA's investing in passives funds where reduced fees have been negotiated by LCIV are charged from the first full month after subscribing to the passive fund

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# Passive Funds Fee Proposal

## Introduction

1. Over a period of several months in 2015 and 2016, LCIV engaged with the London Local Authorities' (LLA) passive fund providers including Legal and General Investment Management (LGIM) and Blackrock Asset Management to create an opportunity for LCIV to hold the LLA passive assets on the LCIV Authorised Collective Scheme (ACS).
2. Through a number of conversations with both LGIM and Blackrock and discussions of a of possible models and implementation requirements, it became clear in the first half of 2016 that moving the passive assets into LCIV would be both extremely complex and expensive. This result, coupled with the Government announcement that Life Funds could be held outside of the Pools (an announcement at odds with its previous position), led LCIV to focus on negotiating fee reductions with LGIM whilst the LLAs continued to hold existing life policies. This would deliver benefits to the LLA's from mid-2016 and allow resources at LCIV to focus on other key projects to deliver wider benefits to investors.
3. Discussions with BlackRock have also been ongoing and LCIV facilitated a session in October where proposals were presented to investing LLA's by BlackRock. These proposals are currently being reviewed, with further discussions taking place over the next few weeks. It is hoped that options which deliver savings benefits to those investors will be agreed soon.
4. The LGIM negotiations concluded in August 2016 resulting in substantial reductions being applied to existing LLA policies across both equity and fixed income assets. The aggregated annualised savings across the LLAs amounted to £1.8 Mn with the fee reduction backdated to 1st July 2016.
5. A view has been put forward to LCIV that a substantial amount of work and cost (including legal advice) was undertaken on behalf of the LLAs invested in LGIM and that, although the assets are not held inside the CIV, the time and cost to achieve the fee reductions should be offset by a charge to LLAs benefitting from the fee savings. This view has been expressed by a number of LLAs, some of whom are and are not invested with LGIM.
6. To address this view, LCIV was asked to consider potential passive fee options and provide a proposal for consideration by the LLAs for implementation in financial year 2017/18. The following provides a summary of the fee options, selection criteria, fee levels and LCIVs recommended fee structure.
7. It should be noted that, in addition to the Government announcing that Life Funds could be held outside of the Pools, the Government also said "it is expected that the management and reporting regarding these life funds is done within the pool".. LCIV has not yet assessed either the requirements or potential costs of this management and reporting process. If the required process introduces substantial costs, LCIV may need to discuss potential adjustments to the passive fee levels to cover these additional costs.

8. LCIV have been and continue to work closely with the 2 main passive providers in London to monitor developments and to ensure that future opportunities in the passive arena are made available to LLA's at agreed fee rates. In addition LCIV is working closely with LGIM on voting issues, notifying LGIM of any LAPFF voting alerts and receiving confirmation of votes undertaken on behalf of London Funds. These are being reported to the PSJC along with the existing sub-fund manager voting.

### **Passive Fee Options**

9. LCIV has considered a range of options for charging a passive fee. The three key options assessed by LCIV include and are outlined in more detail in Annex A:
  - i. **Assets under Management (AUM).** A basis point (bp) fee based on the level of the individual LLAs passive assets AUM.
  - ii. **Percent of fee savings.** A fee based on a percent of the individual LLAs annual fee savings on passive assets experienced by individual LLAs.
  - iii. **Flat fee.** A flat fee to be charged equally to all LLAs

### **Selection Criteria**

10. In assessing the above fee structures and fee levels, LCIV applied the following criteria:
  - i. **Fairness.** As part of the LCIV charging principles and a priority of the LLAs, the fees should be fair and LLAs should not be charged disproportionately
  - ii. **Implementation.** The data requirements, reporting and invoicing processes, and fee structure should be relatively simple for both the LLAs and LCIV to implement and not add substantial operational complexity or cost for the LLAs or LCIV
  - iii. **Net Benefits.** All LLAs should continue to have a net benefit after the fee is applied.
11. A summary of the fee options in paragraph 8 and assessment can be found in Annex A.

### **Passive Fee Structure Proposal**

12. LCIV believes that option (i) in paragraph 8 above, a fee based on AUM, is the most viable option and proposes this option for adoption by the Committee. The fee would be calculated on each LLAs passive assets AUM at the end of each month and invoiced annually at the end of each financial year.
13. In addition, LCIV has considered the basis point fee levels of a quarter bp (0.0025%) and a half bp (0.005%). A summary of the potential fees per LLA based these potential bp level and AUM as of 31st December 2016 can be found in Annex B. The Committee is asked to consider the fee level options in Annex B and provide guidance to LCIV of the preferred approach.
14. The recommendations and agreed approach will then be put to the Board of LCIV for final agreement prior to implementation.

## **Recommendations**

15. The Committee is recommended to:
- i. Adopt an AUM based fee to be charged to the LLAs benefitting from reduced fees negotiated by LCIV on any passive funds managed outside of LCIV
  - ii. Consider the fee level options in Annex B and agree preferred fee scale to be charged; and
  - iii. Agree date of 1st April 2017 for implementation of passive fee charges to commence and a review of the fees after five years.
  - iv. Agree that LLA's investing in passives funds where reduced fees have been negotiated by LCIV are charged from the first full month after subscribing to the passive fund

## **Financial implications**

16. The new passive fee would impact LLAs benefitting from the LGIM fee reductions as outlined in Annex B.

## **Legal implications**

17. Implementation of the passive fund fee will require a data sharing arrangement to be put into place between the LLAs, LCIV and passive fund managers

## **Equalities implications**

18. There are no equalities implications for London Councils.

## **Annexes**

Annex A: Summary of fee options and assessment

Annex B: Illustration of potential fees to be charged to LLAs based on basis point levels.

## ANNEX A

### PASSIVE FEE STRUCTURE OPTIONS AND ASSESSMENT

Option	Description	Pros	Cons
<b>OPTION 1</b>  <i>Fee based on AUM of LLA passive funds</i>	<p>Fee charged based on agreed basis point level on AUM of passive funds managed outside LCIV which have benefitted LCIV fee negotiations</p> <p>Fee to be calculated on month end AUM per LLA and invoice annually</p>	<ul style="list-style-type: none"> <li>• Fairness: Aligns with fairness approach as those boroughs paying fee benefitted from LCIV's negotiations</li> <li>• Fairness: AUM based fee ensures LLAs with smaller AUM are not negatively impacted</li> <li>• Implementation: Based on industry standard approach basis point charging approach</li> </ul>	<ul style="list-style-type: none"> <li>• Implementation: Requires L&amp;G monthly charging report to be developed</li> <li>• Fairness: Does not take into consideration the net fee savings per LLA as some LLAs with higher AUM had smaller fee savings</li> </ul>
<b>OPTION 2</b>  <i>Fee based on % of LLA annual savings</i>	<p>Fee charged as a percent of LLA's annual savings on passive funds managed outside LCIV benefitting from LCIV fee negotiations</p>	<ul style="list-style-type: none"> <li>• Fairness: Aligns with fairness approach as those boroughs paying fee benefitted from LCIV's negotiations</li> <li>• Fairness: Savings based charge ensures those who have smaller annual savings are not negatively impacted</li> </ul>	<ul style="list-style-type: none"> <li>• Implementation: Complex charging structure introduction accounting complexities for LLAs and LCIV and requires annual agreement on fee savings per annum</li> <li>• Implementation: Base of fee savings calculations would need to be completed annually on each type of passive fund and agreed with the LLAs</li> <li>• Implementation: New LLA investors would have no basis to calculate fee savings and a base savings level would need to be agreed</li> </ul>
<b>OPTION 3</b>  <i>Flat fee</i>	<p>Flat fee charged annually to LLAs invested in passive funds managed outside LCIV benefitting from LCIV fee negotiations</p>	<ul style="list-style-type: none"> <li>• Fairness: Aligns with fairness approach as all LLAs pay the same fee and LLAs paying fee benefitted from LCIV's negotiations</li> <li>• Implementation: Simple fee structure</li> </ul>	<ul style="list-style-type: none"> <li>• Fairness: Does not take into consideration the relative levels of AUM level or annual savings across LLAs</li> </ul>

## POTENTIAL FEE CHARGES

Summary of potential passive fund fees per London Local Authority (LLA)					
#	London Local Authority	AUM as of 31st Dec 2016 (£) <sup>1</sup>	LGIM June 2016		Charge (£)
			Estimated Annualised Gross Fee Savings based on AUM (£)	Basis Point	
				0.0025%	0.0050%
1	Royal Borough of Kensington and Chelsea	276,220,962	235,139	6,906	13,811
2	London Borough of Haringey	1,000,243,022	165,334	25,006	50,012
3	London Borough of Newham	325,181,909	149,731	8,130	16,259
4	London Borough of Southwark	394,131,820	224,207	9,853	19,707
5	London Borough of Richmond upon Thames	303,361,980	183,706	7,584	15,168
6	London Borough of Brent	356,150,416	186,434	8,904	17,808
7	London Borough of Barnet	415,846,755	171,723	10,396	20,792
8	London Borough of Camden	504,135,796	143,812	12,603	25,207
9	London Borough of Hammersmith and Fulham	278,621,582	198,179	6,966	13,931
10	London Borough of Islington	90,303,711	77,933	2,258	4,515
11	Westminster City Council	267,741,961	181,220	6,694	13,387
12	London Borough of Sutton	68,409,216	23,194	1,710	3,420
13	London Borough of Tower Hamlets	327,812,128	83,787	8,195	16,391
14	London Borough of Croydon <sup>2</sup>	535,574,667		13,389	26,779
	<i>Total</i>	5,143,735,923	2,024,397	128,593	257,187
	<i>Potential Fee as a percent of total annualised fee savings of £2 Mn</i>			6%	13%
	<sup>1</sup> AUM based on LGIM report of AUM value per LLA as of 31st December 2016				
	<sup>2</sup> Croydon outside scope of fee savings due to nature of mandate being outside of main Life Funds in a segregated account.				
	<i>Note: Where additional Funds invest and receive the lower LCIV rate card, they will also receive a fee charge from first full month of investing</i>				