

## **LGPS UPDATE: POOLING OF INVESTMENTS**

### **Report of the County Treasurer**

Please note that the following recommendations are subject to consideration and determination by the Committee before taking effect.

**Recommendation: That the Committee notes the work undertaken to date in response to the Government's investment pooling agenda.**

#### **1. Introduction**

- 1.1. As reported at the last meeting of the Committee, the Government announced in the July budget statement that they intended to work with Local Government Pension Scheme administering authorities to ensure that they pool investments to significantly reduce costs, while maintaining overall investment performance.
- 1.2. In response to the Government's announcement the Committee resolved:
  - (a) that approval in principle be given to the establishment of a South West Collective Investment Vehicle;
  - (b) that the County Treasurer be authorised to continue work with neighbouring funds in the South West to establish proposals for a South West Collective Investment Vehicle;
  - (c) that the Committee remain open to considering alternative pooling options in order to fulfil their obligation to provide best value for fund Members.
- 1.3. This report updates the Committee on the latest developments and the work undertaken to date.

#### **2. Government Policy**

- 2.1 At the Conservative Party Conference the Chancellor of the Exchequer announced that the Government intended to pool the LGPS funds into six "British wealth funds" with the aim of investing billions in regional infrastructure. The Government have subsequently clarified that this is the same policy announced in July of requiring local funds to pool investment assets, building on the discussions already taking place between the Government and the LGPS sector, but places infrastructure investment, alongside delivering efficiencies, at the heart of the policy.
- 2.2 The general perception is that infrastructure is an attractive asset class providing inflation linked returns, but that local LGPS funds lack the resources to invest directly. Therefore asset pooling would encourage

greater investment in infrastructure. The average LGPS fund allocation to infrastructure is around 1%. The Devon Fund has committed 4% of the Fund to infrastructure via fund arrangements, rather than investing directly, thereby pooling its infrastructure investment with other investors and making use of the infrastructure expertise of the managers managing those funds. The perception is that if funds were able to invest directly into infrastructure assets, rather than investing via funds, it would save on the management fees and make the investments more attractive.

- 2.3 It is unclear whether the Government will mandate a certain level of infrastructure investment or investment in specific projects. Pension funds have generally had a preference for investing in established infrastructure rather than new construction work which carries with it a much higher degree of risk. Mandating investment into new infrastructure projects with a high level of construction risk could be subject to legal challenge, as being contrary to the fiduciary duty to make decisions based on what is best for the financial position of the fund. However, the ability to facilitate further investment in infrastructure is likely to be an additional criterion in assessing whether proposals for pooling are acceptable to Government.

### **3. South West Regional Pool**

- 3.1 The proposals to set up a South West regional pooling arrangement have been progressed since the last meeting. Price Waterhouse Coopers (PWC) have been commissioned to undertake work looking at the possible structures for a pooled vehicle and also to estimate potential savings. Members of the Committee and the Pension Board received a briefing from PWC at the recent training day.
- 3.2 PWC have done an initial options appraisal looking at potential cost savings and governance structures. The report looks at the advantages and disadvantages of setting up a separate vehicle using an "Authorised Contractual Scheme" model, a tax efficient corporate entity which would need to be registered with the Financial Conduct Authority (FCA). It also looks at the alternative of a joint committee with a lead authority managing the pooled investments. Further work is required before a firm recommendation is made as to the proposed governance structure.
- 3.3 In addition a working group has been set up to look at how many sub funds should be made available within the pooled vehicle, and the degree to which asset classes will be broken down into more narrowly focused sub funds. This will be a key issue in determining what flexibility the individual LGPS funds will have in their asset allocation strategies.
- 3.4 A further meeting of the eight funds involved is scheduled for 19<sup>th</sup> November to receive a further progress report on the work being undertaken by PWC. An oral update will be provided to the Committee on any issues or outcomes resulting from that meeting.

## **4. Alternative Options**

- 4.1 While work within the South West funds has been progressing, officers have also been keeping in touch with other options. Investment consultants Hymans Robertson have been working with funds across the country to look at different options for pooling, including regional pools, asset class pools or a mixed economy, with the intention of putting together a coherent proposal that fits the Government's agenda. Working groups have been set up to look at the different options and the Devon Fund has supplied data on the Fund's asset allocation, management fee levels and performance to assist with the group's work.
- 4.2 While the Government has stated it has no fixed ideas on the type of pools (regional, multi asset or single asset), leaving that decision to the LGPS sector, it has expressed a preference for a 'simple' solution. In that context it is likely that the final outcome will either result in the Devon Fund pooling all its investments via a South West regional arrangement, or investing via specified pools for different asset classes. It would appear unlikely that there would be an option to pick and choose between different pooled vehicles within asset classes.

## **5. MiFID II**

- 5.1 A further issue that will have an impact on LGPS funds is the Markets in Financial Instruments Directive (MiFID II) from the European Union. LGPS funds are currently regarded as professional clients under various regulations, but the implementation of MiFID II will result in them being reclassified as retail clients. There will be the opportunity to elect for professional client status.
- 5.2 Professional clients are presumed to have a higher level of understanding of the products that they are investing in and therefore will receive a lower level of protection than retail clients. As a retail client, the Fund could be faced with a much reduced pool of asset managers and consultants willing to provide services, many may not deal with retail clients at all. Those managers who are willing to deal with us will offer a restricted range of products and due to the extra compliance checks and reporting required for retail clients those products could cost more. First estimates are that up to 50% of LGPS assets may be affected.
- 5.3 If when the directive comes into force (January 2017) the Fund holds assets in products outside of the scope of those available to retail clients, then the manager may eject us from that product resulting in a 'fire sale' of assets. This could be mitigated if the Financial Conduct Authority were to provide some form of transition period or 'grandparenting' - allowing the retention of products purchased as a professional investor for a period of time.
- 5.4 The Devon fund will therefore need to take action to elect to opt up to professional status. This will involve demonstrating that the fund can meet a range of qualitative and quantitative criteria, and probably involve completion of a significant amount of paperwork for each of the managers employed. MiFID II will also be a consideration in deciding the governance arrangements for pooling investments as it is likely that an FCA approved Authorised Contratual Scheme would automatically qualify for professional client status, while other forms of governance may not.

## 6. Conclusion

- 6.1 It is anticipated that the criteria against which proposals for pooling are to be assessed will be published by the end of November alongside a consultation on:
- new investment regulations (with the removal of any limits or restrictions which would prevent pooling);
  - back stop legislation which will apply if any fund is not invested via a vehicle/s which meet the criteria;
- 6.2 The work being undertaken now should result in proposals on a direction of travel (likely pools and which funds will be in them) going to ministers early next year. Further and more detailed proposals would then be expected later in 2016. The work being done both with the other South West Funds and Hymans Robertson should put us in a good position to influence the final outcome.
- 6.3 An announcement by government on the way forward is likely in Spring 2016.

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Electoral Divisions: All

Local Government Act 1972

List of Background Papers – Nil

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