Leaders' Committee

Pensions Working Group: Progress update

Item no: 6

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Summary

This report follows on from previous discussions on the potential for more collaboration between those London Boroughs that wished to do so, on the management and investment of pension funds.

It concludes that the focus of any such collaboration should be to optimise investment returns whilst the potential to make administrative savings, whilst important, should be the secondary consideration.

The report has been prepared by officers from London local government and London Councils supporting the member led working group established by Leaders' Committee towards the end of 2012.

Whilst there are several options for voluntary collaboration, a Common Investment Vehicle (CIV) is seen as the model which offers the best potential and it is recommended that further detailed work is undertaken on governance and a procurement strategy so that a fully worked up proposal may be submitted for future consideration.

Recommendations

Leaders' Committee is recommended to:

i. Note the work undertaken by the Working Group on considering the route towards establishing a potential CIV;

ii. Commission the Working Group, to undertake further work, and report back on those issues which would need to be addressed in the setting up of any future CIV, including:

a. Detailed consideration of possible governance mechanisms;
b. A potential procurement strategy; and
c. Options for establishing a possible host entity or Special Purpose Vehicle.

iii. Agree in principle to move towards a CIV for those boroughs who wish to, subject to Leaders' Committee consideration of the outcome of the further work by the Working Group.

Pensions Working Group: Progress update

Background

1. The issue of potential economies arising from merging the administration and investment arrangements has been under discussion for a number of years. In March 2012, Leaders' Committee received a report from the London Pensions Fund Authority (LPFA) on the potential for a London pension mutual and a common investment vehicle (CIV). The Society of London Treasurers (SLT) also provided advice to Leaders' Committee on the potential for both a mutual and a CIV. The SLT advice also raised a number of questions that it suggested would need addressing before any final decisions could sensibly be taken. Leaders' Committee commissioned further work to be done to looking at the questions raised. Following that meeting, SLT then commissioned work from the consultants PwC which was presented to the 13 November 2012 Leaders' Committee meeting. The report addressed the questions raised by SLT and identified four possible options that could provide ways forward:

   a. Collective Investment Funds,

   b. London Framework Fund,

   c. Common Investments Merger and a

   d. Full Merger.

2. The PwC report only considered the first two options as potentially viable at the present time.

3. Following discussion in November 2012, Leaders' Committee resolved that a small working group of members and officers should be formed to consider the advice from PwC in more detail and to report back with recommendations before the summer of 2013. A report to the 11 December meeting of Leaders' Committee proposed terms of reference and membership (the three Group Leaders and representatives from SLT) for the group.

4. The consensus among the Working Group is that although some savings could accrue from the joint administration of investments and/or benefits administration, the largest financial benefit to London pension funds would accrue from better investment returns and this should be the focus of attention. With that in mind it was agreed that the SLT representatives would conduct a survey of the Society to see what the appetite would be to work towards a CIV.

A Collective Investment Vehicle

5. A CIV (or fund) is a structure whereby each of the participating boroughs - and it should be stressed that participation by boroughs would be voluntary - would retain autonomy in asset allocation and funding strategy. There would be a host entity, or Special Purpose Vehicle, working within new governance arrangements, that establishes a choice of funds within each asset class, selects fund managers and negotiates and monitors fee and service levels. The participating boroughs would set their asset allocation, choosing between wide ranges of Investment Funds offered.

6. SLT members were surveyed and 26 responses were received, none of which were against the concept of a CIV, although the majority said that they would need to know more before definitely deciding whether to use such a vehicle. However, despite this element of natural caution, it is considered that such a vehicle should be further investigated, particularly in the light of other changes happening in the wider LGPS landscape.

7. SLT representatives also met with Aon Hewitt who are engaged in a similar review in Wales. There, grouping Welsh LGPS assets into a collective investment vehicle is the recommended way forward as it is believed to be an attractive model which could deliver the same benefits as a wholesale merger, particularly greater investment returns and fund efficiencies, but without the associated transition costs, complexity or lengthy implementation timescales. A note summarising the work of the Welsh group is appended.

8. SLT has also noted a number of press statements from the LPFA which talk about "One Fund for London" but it is not thought that there has been any formal dialogue with the London Boroughs on this.

View of Central Government

9. The publicly stated view of the Government as to the working of the 100 plus LGPS schemes in the UK has been, until recently, that there were no plans to actively merge schemes. However, the following extract from the January 2013 Local Government Pension Scheme Policy Review Group is informative1.

    i. "*DCLG explained that Ministers believed that the case for amalgamation should be properly examined. There would be a call for evidence in the next six months. Funds were not generally supportive of full merger. Fund merger*

[1] http://www.clg.heywood.co.uk/system/files/PRG+minutes+10+Jan.doc

would necessitate increased borrowing. There would also be a need to legislate and Ministers were reluctant to do this. There was a view that London would be a target area for mergers, but the performance of a number of London authorities had improved from below the average to considerably above in recent years. It was felt that the end result of such considerations was likely to be increased collaboration, particularly regarding investment."

10. Subsequent to that meeting, the LGA is convening a pensions round table on May 16th at which the SLT will be represented and at which the Minister (Brandon Lewis MP) will attend to open the session and share his thoughts in this area. It is understood that these views will include a desire to reduce the number of funds nationally. It is unclear at present whether, if this is so, this would be via compulsion or on a voluntary basis. However, the retention of the status quo is unlikely to be on the Government's agenda.

11. At its meeting on April 19th, SLT discussed further the options available to London collectively and concluded that the retention of the current arrangements of 33 borough level funds working within their individual arrangements was unlikely to be tenable in the long-term future. It also felt that a CIV was the practical option for joint working in the short to medium-term and that, for some of the boroughs, this could be a first step to voluntary merger(s). A merger by compulsion was not supported for a variety of reasons, including current and future cost, risk of cross subsidy and loss of democratic oversight.

Establishing a CIV

12. As stated earlier, the savings from aggregating administration are relatively minor compared to the benefits from better investment returns. Neither is there compelling evidence that the 'bigger is better' argument wins against the 'small is beautiful', or vice versa. However, there is evidence that there is a wide divergence of performance in London which is not related to fund size and more to asset allocation decisions. In the light of this and the consensus to explore further collaborative working on a voluntary basis, there is an immediate need to investigate the setting up of a CIV enabling boroughs to pool resources to improve the position not only in respect of fee levels, but try and achieve better performance overall.

13. The establishment of a CIV would need either a host entity or the establishment of a Special Purpose Vehicle (SPV). The former would be quicker to establish than the latter and the host entity could conceivably be a lead borough, London Councils or the LPFA

for example. It would be premature to recommend any of these as a preferred option at this point and, undoubtedly, legal advice would be needed before any such recommendation could be made.

14. Some initial work has been undertaken on the timescale for setting up a CIV in terms of the appointment of an investment fund advisor. At present, the 33 London funds employ 10 different advisors, although 3 firms account for 24 appointments. The procurement of a fund advisor for the CIV would involve an EU tender and the likely timescale would be in the region of 9 months from decision to commencement of service. Once this was in place decisions could be made on fund managers. Based on initial legal advice, the latter would be a non EU procurement and would be based upon the recommendations of the approved fund advisor.

15. There has been some suggestion that the fund managers could be directly employed by the CIV and this was suggested by LPFA in their original suggestion. However, this would need further research

16. The costs of establishing a CIV with funds in the region of £2 billion, which is 10% of London borough funds under management as at March 2012, would, based upon some initial market soundings, be in the region of £600,000-£900,000 depending upon how many fund manager categories are appointed and the level of devolvement by individual boroughs to the CIV, and the level of set up costs to be recovered from future running costs. However, this represents 0.03%-0.045% (3-4.5 basis points) of the funds under management and a saving of that amount should be achieved on reduced fees achieved through the tendering exercise.

<u>Some Governance Considerations</u>

17. Initial funding for a host entity or SPV would come from participating authorities, but once established would be more than paid for from reduced fees. The lead body would procure an investment advisor followed by a transition manager and investment funds/fund managers within each asset class, including alternatives like infrastructure.

18. The CIV would maintain a “best of breed” selection of funds/ managers for each asset class. These would be well defined, generally segregated mandates, with the CIV using its buying power to secure lower investment manager fees. The CIV would be responsible for day-to-day governance in relation to each selected manager, including, in conjunction with the appointed investment advisor, performing necessary due diligence for the chosen managers. This would include quarterly meetings with

managers and providing quarterly reports for borough pensions committees that summarise performance and any other pertinent information for the due diligence.

19. Boroughs would be free to choose which, if any, manager, to use from the CIV. Boroughs would not be compelled to use any CIV manager, but clearly, best-in-breed managers at the lowest cost obtainable should make the selection of managers desirable. One of the first asset classes to be investigated would be Infrastructure.

20. Individual funds would retain their own custodians, control over asset allocation, and accounting responsibilities, although manager related information would be supplied by the CIV. In time, the CIV could also be used to provide any other officer related investment duties that boroughs voluntarily wished to delegate, for instance if key staff left a particular borough – this could extend to preparing draft reports for all investment related matters for the local pensions committee, using a common custodian and preparation of accounts etc.

21. If and when appropriate, funds/managers would be deselected and recommendations for change would be made. Boroughs would be free to focus their investment governance budget on the asset allocation – the key driver of investment performance.

22. The Common Investment Vehicle model would not affect the triennial valuation process which would remain as currently.

Next Steps and Recommendations

23. The establishment of a CIV for pensions investment operated on behalf of the boroughs is clearly feasible and with a minimum level of buy in is potentially financially attractive. However, it does require a level of buy in at a political as well as technical level from councils to establish whether the initial interest of boroughs can be converted into real interest to make the initial investment in setting up the CIV worthwhile.

24. Leaders' Committee is recommended to:

    i. Note the work undertaken by the Working Group on considering the route towards establishing a potential CIV;

    ii. Commission the Working Group, to undertake further work, and report back on those issues which would need to be addressed in the setting up of any future CIV, including:

        a. Detailed consideration of possible governance mechanisms;

        b. A potential procurement strategy; and

c. Options for establishing a possible host entity or Special Purpose Vehicle.

iii. Agree in principle to move towards a CIV for those boroughs who wish to, subject to Leaders' Committee consideration of the outcome of the further work by the Working Group.

Financial Implications for London Councils

None at this time

Legal Implications for London Councils

None at this time

Equalities Implications for London Councils

None

Appendices

Annex A: Welsh Local Government Pension Funds Working Together, March 2013

Background Papers

13 March 2012 Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=4796

13 November 2012 Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5072

11 December 2012 Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5109