APPENDIX II

London LGPS CIV Seminar
5th February 2014

Summary of Questions and Answers

Introduction

The s.151 officersand pension officers from many of the London Boroughs met on 5th February 2014, to discuss thePension Working Group's report to Leaders' Committee on the progress of the project to develop a Collective Investment Vehicle (CIV). The session addressed a number of questions from officers, with the key area of discussion around governance issues. A summary is set out below.

Aspects of the report

1. **Regarding the recommendations, should the decisions be made by local pension committeesrather than at full council meetings?**

   The decision making process will vary between boroughs, and depends on the delegation of powers at each borough. It is thought that in most cases, a full council meeting will be required to agree to the creation of the new joint committee.

   It should be noted that decisions made now do not tie boroughs into investing in the CIV in the future. Nothing in the current paper requires a decision as to whether boroughs wish to use the ACS for pension investment.

2. **How many positive responses from boroughs are required to continue the project?**

   London Councils would require sufficient quantum and enthusiasmfor the project in order to continue to act on behalf of the London boroughs collectively; however there is no set number of responses required.

   Nevertheless, we are mindful of the local elections, and how this may affect each borough's ability to reach decisions, and the position will be monitored over the coming weeks.

   For boroughs that cannot reach a decision now, the option to join later will always remain open.

   [**NB**. The positive response received to the report at the 11 February Leaders' Committee meeting makes it easier for London Councils to continue in its facilitation role.]

3. **How concrete is the proposed timeline for the launch of the ACS and ACS operator in order to take things forward?**

   The proposed timeline shows the possible time it may take to launch the ACS and the ACS Operator, and the work that needs to be completed. There is a minimum period of time that will be required to negotiate contracts and prepare FCA applications, and the amount of time the FCA may take to consider the application can vary (it is likely that the FCA will require 6 months to review the applications for the ACS and the ACS Operator although it cannot be guaranteed that both applications will be reviewed concurrently). As such, the timeline is only indicative, but based on previous experience it is a reasonable estimate.

4. **The report suggests £5bn of assets is a sensible target.If the £5bn threshold is not achieved what are the implications?**

   Analysis has suggested that £5bn of asset within the fund would be a sensible target to achieve the economies of scale which have previously been identified; however it is not a critical target size. If the fund size is smaller, the costs would increase per borough, as each borough would pick up a larger share, but this does not mean the costs would outweigh the benefits. Again, this will need to be monitored as the project progresses.

The proposed structure

5. **The report is brief on the benefits of the ACS itself. Why is the ACS vehicleconsidered most appropriate?**

   There are a number of advantages of using an ACS for the fund, including:

   - It is tax efficient e.g. for VAT there is an exemption on investment management fees, ensuring that VAT costs do not increase for the boroughs.
   - As the ACS is tax transparent, the withholding tax benefits the pension funds are currently entitled to can be maintained.

   It is also worth noting that the ACS structure was developed by HM Treasury, and launched last year, as an attractive alternative to other similar vehicles based in Ireland and Luxemburg. As such, they are very interested, and broadly supportive, of our proposals.

   The selection of an ACS as the most appropriate fund vehicle wasset out in greater detail in a previous report to Leaders.

6. **Will the nominated interim directors have the required skills and qualifications to fulfil the role of directors in the ACS Operator?**

   One point to emphasise is that the interim board of directorsis not intended to remain in place after FCA authorisation. It is temporary. It is there to steer the initial set up phases to assist in progressing the detailed work. The suggested interim directors are current Pensions Working Group members and have been involved in this project from an early stage.

   The interim directors will be representing you and the company to facilitate it being established.Going forward new appointmentswill be madefrom candidates who are confirmed as suitable by the FCA.Selecting who these individuals may be, and deciding on the selection process, will be one of the tasks for the next phase of work.

7. **What are the risks associated with the ACS?**

   This model is an authorised scheme by the FCA and so is heavily regulated. It is more highly regulated than similar funds in both Ireland and Luxembourg. As such, the risks are as if you were to make any normal investment. These risks include:

   - Incorrect valuations
   - Holding misrepresented on the register
   - Fraud

   These risks will exist in the fund, however there will be controls in place to mitigate these risks. This involves both legal clauses in contracts, and having the people with the correct skills, knowledge and expertise to manage the fund.

Regarding tax risk, the key tax risk is that the pension fund's investments are less tax efficient than they would have otherwisebeen. HMRC have provided assuranceswith regards to this vehicle to seek to provide comfort, for example, by confirming a VAT exemption on investment management fees.

8. What measures have been taken to prevent the ACS going bust? What would happen to the assets?

ACS operator is a limited liability company, in order to protect shareholders. It will have significant capital, which would mean that,although the ACS operator could be closed down if the participating boroughschose to,it is very difficult for it to go bust. This is because the London boroughs will own the entity and so will control it as shareholders. The ACS will only have a maximum of 33 'clients' and so will be acutely client focussed in its approach.

The assets would be protected legally since they will be ring-fenced through the corporate entity, the ACS operator company. If the decision was made to close down the ACS the current value of the investments made would be returned to investors (subject to payment of any charges and any change in value caused by movement in the market).

The board of directors of the company will be responsible for monitoring the performance of the funds and so will receive detailed reporting on a regular basis. As boroughs are involved, there should be sufficient warning if it is felt the ACS is not providing value and boroughs wish to remove their funds.

If action was taken to wind up the ACS, it should be noted that the FCA will not allow the participants in the ACS to drop to a level where all the costs of closure would be borne by a few remaining participatingcouncils in the vehicle. If any such action was taken significant redemptions would be managed to prevent few investors suffering the closure costs involved.

9. What assurances can you provide that HM Government will not intervene?

The risk of Government intervention must be taken into account, but London Councils have been maintaining activedialogue with the Department for Communities and Local Government. Nothing from this dialogue has given London Councils reason to believe that the current direction of travel will be stopped. London Councils believe the structure delivers much of what central Government are seeking to achieve. The Government are exploring the options for the reform of the LGPS, but it seems unlikely that any reforms will be mandated at this stage.

10. How confident are we that the identified savings will be made?

Avery high level summary of the potential savings and costs have been provided in the report delivered to Leaders. The savings included here are based on work previously undertaken by PwC.

From some initial discussions in the market, it is considered that fund managers would be able to provide volume discounts due to the size of the fund.

As an example, analysis of data provided by the councils to Wandsworthshowed that 7 councils use the services of the same fund manager, which has an ad valorum fee, with a total investment of c £750m.If those councils had pooled their assets through the ACS, then by not each having to pay higher fees on the first part of their investment, the overall fee saving would have been approximately £750k p.a. This is a simpleexample from the initial analysis, but indicates that savings that can be made through the ACS structure.

It was also noted that if the overall performance of the boroughs had been in line with the top performers, overall improved returns of close to £100m would have been achieved. Even if these mandates had been passive this could have resulted in a saving of £50m. These figures illustrate the potential benefit of a pooled approach, albeit future returns cannot be guaranteed.

11. How will the CIV be better equipped at selecting the fund managers than the boroughs are now?

There is of course no guarantee to this. However, the vehicle will have a core staff team looking after the fund, taking advice, and being able to spend more time on analysis on a full-time basis, and not as a smaller part of an existing and already busy day job, as can be the case now.

12. How would mandates such as Infrastructure or Real Estate be governed? Is there a risk fund investments could be politicised?

As a regulated company the ACS will require a robust governance structure that recognises the need for close engagement with its ‘clients’, whilst ensuring that its investment decision making is independent.

Any mandates for alternative assets will be considered by the ACS Operator, and discussed with the boroughs (as ‘clients’) in advance of being offered. As investors, each borough Pension Committee will be able to choose whether to invest in such mandates (and any such decision will need to comply with any investment restrictions applicable to a borough).

Similarly, if a number of councils wanted to make investments with a particular strategy, for example ethical investments, it may be that the ACS could offer this as one of the options should there be sufficient interest, but it would be for each borough to choose if this was one of the mandates it would invest in.

Currently, the Government cannot control the mandates of a regulated fund such as this. Therefore, they would need to change regulation if they wanted to do this.

[NB. An infrastructure fund ‘think piece’ will be developed in the coming weeks for discussion with the Pensions Working Group and boroughs.]

13. Will boroughs need to go through a procurement exercise to invest in the ACS?

If the scheme is kept to just the 33 London councils, then there should not be a need for individual boroughs to undertake procurement. Legal advice will be shared on this point. If the fund is offered more widelythis will need to be consideredfurther, but only in the context of the impact on those other local authorities seeking to join.

If boroughs wished to market test the ACS by undertaking a procurement exercise they would of course be able to.

14. Is there a risk other investment managers would undercut the fees offered by the ACS in a procurement exercise?

The ideal scenario is that the market will support the ACS and undercutting does not happen, although it would demonstrate further that better value has been driven by the existence of the CIV. It should also be noted that fees are not the only consideration when undertaking procurement, it is considered there is not a comparable offering in the market, where the mandates available have been so tailored to the needs of the London boroughs.

15. If the government wants the structure to be adopted across the UK, what are the implications?

A number of authorities are watching the developments here in London. In terms of this ACS, it may be that you choose (as owners) that other non-London LGPS funds can come in as investors, however they would not be shareholders of the Operator, and as such would not participate in decision making in the same way the participating London boroughs would.