LGA Briefing: Pooled investments

This briefing sets out the policy clarification emerging since the Summer Budget announcement on pooling investments in the LGPS.

Background

1. On 7th July the chancellor made two announcements (one via the red book, the other in the speech) that will have an impact on the LGPS.

2. The first, and of more immediate concern, was the announcement of a consultation on legislation for delivering savings via the use of pooled investment vehicles for LGPS fund assets.

3. The document which accompanies the budget and is published immediately the chancellor sits down (the red book) contains the detail of the major announcements made in the chancellor's speech to the House together with those announcements which for whatever reason were not included in the speech.

4. The red book contains at page 78 the following section

   2.19 Local Government Pension Scheme pooled investments *– 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.*

5. This briefing sets out the clarification on policy which has emerged since the Summer Budget announcement on pooled investments. It includes the key messages which are now becoming clear; a brief note of the meetings held on the subject; and a description of the options for pooling currently under discussion.

Key messages

6. Since the budget announcement the following key messages have emerged in discussion with DCLG/HMT officials:

   a) Proposals for pooling will need to be assessed against criteria to be set by government. The budget statement is potentially misleading in that the consultation on the criteria is happening now not in the autumn.

   b) Criteria are likely to be around size (£30b has been used as an illustrative example), cost and governance. However there will be no specific savings target in the cost criterion. A forth criterion on infrastructure is expected to be added following the chancellor's speech to the Conservative party conference on 5th October.

   c) This additional criterion is not expected to be prescriptive but will aim to provide an environment in which cost effective infrastructure investment opportunities may be better accessed by the LGPS.

   d) We expect the criteria will likely be published in November alongside a consultation on:

      - new investment regulations (with the removal of any limits or restrictions which would prevent pooling); and
      - ‘back stop’ legislation which will apply if any fund is not invested via a vehicle/s which meet the criteria;

   e) Thoughts about pooling models and options should be underway now with a view to 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.

   f) Announcement by government on the way forward likely in Spring 2016.

g) Asset allocation is to be left at the local level, but as yet there is no guidance on the exact nature of this allocation (e.g. at the class or sub class level?).

h) Government has no fixed ideas on the structure of pools (CIV, CIF, joint procurement etc.) that decision is being left to the sector.

i) Government has no fixed ideas on type of pools (regional, multi asset or single asset) again, that decision is with the sector. However it has expressed a preference for a 'simple' solution.

j) Government is alive to the transitional issues for example illiquid vehicles that cannot be unwound in the short term without significant financial penalties. It is also aware of the time that structures such as the London CIV have taken to set up. However it will probably expect pooled vehicles to be in place in this parliament even if all assets will not be ready to be moved within that timeframe.

k) There may be a place for a proportion of the assets to remain under direct local control in certain circumstances. However any such exemptions would probably be for prescribed investments and will be small.

Meetings

7. A number of recent meetings have taken place on this subject organised both by the LGA, in response to a request from DCLG to facilitate discussions with stakeholders, and the Scheme Advisory Board (SAB).

8. LGA organised a fund officers/DCLG/HMT meeting on the 17th August, followed up with a further meeting on the 7th September, to encourage thinking around the criteria and possible models. The key outputs of these meetings were that funds:

- Remain unconvinced that there are any intrinsic benefits of scale especially for in house teams with already low costs.
- Do not see CIVs as the only method of pooling.
- Interpret 'asset allocation' in a number of different ways.
- Can see some benefits to pooling in some asset classes but would want to retain some local discretion.
- Anticipate reduced fees especially for alternatives, provided pools are well governed.

9. The LGA also organised an investment managers DCLG/HMT meeting on 24th August to solicit the views of the industry. The key outputs of this meeting were that managers:

   - Were less concerned about the background structure of any pool and more concerned on the need for it to present itself as one client.
   - Would encourage as much decision making as possible be placed within the pools in order to achieve the greatest savings.
   - That pools if structured correctly could provide the 'sticky mandates' necessary to remove unnecessary churn.

10. The SAB held an open invitation session on 21st August for all funds. There were over 60 attendees (the vast majority officers) representing 45 funds. A copy of the Q&A from this session is attached as **ANNEX 1**.

11. LGA held a meeting for chairs of pension committees on 16th October. A number of issues were raised mainly around timing of proposals, the need to obtain political agreement, the potential exemptions and the potential for competing pools. The issue of co-ordination in order to ensure that all funds are involved in the proposals was also raised.

Potential models

12. Making an assumption that around £30b is the target for multi asset pools, with perhaps a smaller number for single asset pools which could be

evidenced to operate better at the national level; then a number of potential options for pooling emerge:- PLEASE NOT LGA are not supporting, proposing or seeking to achieve any of these options and the following are listed for information only

- Six or seven[1] regional multi asset pools
- Six or seven national multi asset pools - funds could join pools with similar investment strategies or methodologies (e.g. in-house)
- Four or five multi asset pools (regional or national) with a single national framework for passive
- Four or five multi asset pools with a national pool for a single asset class (e.g. infrastructure)
- Four or five multi asset pools with a single national framework for passive and a national pool for a single asset class
- Three or four multi asset pools with single national framework for passive, a national pool for a single asset class (e.g. infrastructure) and a single pool for fixed liabilities (e.g. a pensioner pool)

13. For pools themselves there are a number of different potential structures which are under consideration these being:

    - Joint procurement (e.g. the passive framework)
    - Joint vehicles (e.g. the LPFA/GMPF infrastructure pool)
    - Combined vehicles (e.g. the London CIV and Lancs/LPFA models)
    - Delegated functions (e.g. section 101(5) committee with lead authority)

14. For the latter two a degree of in-house management is being considered either to replicate what is already there or to build extra capacity.

15. In order for funds to be able to compare a number of the options a group of LGPS funds are working with Hymans Robertson to undertake an analysis of

[1] Depending on the participation of Welsh funds in cross border pools or one Welsh pool.

options with a view to assessing how each performs against the following criteria:

- Size - are the multi asset pools sufficient to meet the assumed government criteria of £30b, are the other vehicles optimally sized for their class or method?
- Costs - what are the estimated gross savings for each option?
- Governance - how do each of the models provide political structures and behaviours that encourage best practice outcomes (e.g. long term investment)?
- Local political direction - who is working with who already, where are the obvious fits?
- Central political direction - are there other policy drivers which the options best fit with (e.g. combined authorities)?
- Impact on competition - both in the manager market and between pools.
- Legislative requirements - what is needed and what would be the time frame needed?

16. The data from the above analysis will be made available to the stakeholders and in this respect the LGA's Head of Pensions will liaise with the steering group managing this work.

How LGA can help

17. The LGA pensions team can provide cross scheme data from the Scheme Annual Report to enable funds to assess the potential assets pools across England and Wales.

18. LGA can co-ordinate the process by making funds aware of the pooling projects underway and providing a central contact point for funds who are exploring their options and may wish to talk to more than one project.

19. The LGA Head of Pensions is able to attend joint or single meetings of officers and/or elected members in order to set out the background and current understanding of the process.

20. The LGA can make representation on behalf of LGPS funds back to government and/or facilitate contact with DCLG and HM Treasury officials who are leading on the process.

21. If you would like further information on how the LGA can provide support please contact:

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ANNEX 1

Questions received for 21st August Pooled Investment Event.

Q1. The current regulatory framework within which the LGPS operates makes it difficult for funds to collaborate on investments without a requirement to achieve FCA registration which entails additional cost and complexity. It should be possible to revise the Investment Regulations to allow funds to work together, within guidelines, without unnecessary regulation.

Are ministers receptive to a revision of the regulatory framework to enable funds to work together more easily? If so, will this be undertaken at the same time as the pooling consultation?

A1. Yes, as part of the package, government will consult on revising the investment regulations. It has been noted that the initiatives to be implemented in the near term, i.e. the London CIV, have needed to work through barriers in order to get the current stage. Amended investment regulations would be required to facilitate ease of implementation of investment pooling without having to establish third party companies and FCA regulation.

Q2. How do low cost internally managed LGPS schemes fit into their view for the LGPS?

A2. The intention is for all LGPS assets to be pooled, there will not be exemptions for any fund. However, the package for the LGPS is deliberately not over-prescriptive. The criteria for investment pools will include some detail on governance, size, and cost, but it will be up to LGPS funds to work together to uphold proposed investment pools against the criteria.

There is an issue of scale to address, and a need to collaborate with others with the same goals. Government can help proposals through regulatory change.

Q3. Funds are required to demonstrate cost savings, however as investment arrangements are income contracts as returns improve you pay higher fees, arguably you want to be paying more as it demonstrates you are earning more? Is “cost savings” the right question or should it be “Value for Money”?

A3. Both costs and the return on investments are important. It is recognised that i) there are industry-wide issues with investment expenses transparency, and ii) each fund will be starting from a different point. There is evidence to suggest larger pools may be more cost effective, benefitting from economies of scale. The government is *looking at a timescale longer than term of office for any cost savings to fully materialise. Without having set the criteria, questions around demonstrating cost savings against them are difficult to answer.*

Q4. There has not been any work to achieve a consistent fee base or fee budget for the wider LGPS to measure against, so how is the integrity of fee saving submissions established.

A4. LGPS policy has moved on from 2013 when the call for evidence brought investment costs into focus and ignited the passive versus active debate. Since then it has been shown that LGPS Funds had managed to negotiate competitive fee bases. Fee savings are one of the reasons, but not the primary reason, for pooling investments. As above, the criteria have not been set, nor the nature of the pools; therefore submissions would need to be backed up with evidence.

Q5. How are CIV structures more likely to generate savings over shared procurement initiatives, especially as CIV's have an operating cost, governance and access challenges to overcome?

A5. The policy intention would not be met by frameworks and/or procurement initiatives alone. If the end result is that the investments of the LGPS are to be held in four or five robust CIVs, similar to the London CIV, the government would not be disappointed. CIVs, however, were not prescribed in the budget, and there are other, just as acceptable, means for investment pooling.

One of the long term detractors in performance is investment manager turnover; its extent would be reduced as a result of pooling investments. The eventual solutions would need to be considered, backed up by research and require a lead in time to implementation.

Q6. How do we ensure that our proposals are not a patchwork quilt many of which may not meet the size criteria and/or overlap with each other? Do we need a moratorium on any new initiatives while we develop proposals and will be Board be looking to compile responses into a number of cohesive options?

A6. The criteria consultation is a continuum, with the 21st August Q&A/forum forming part of the process. Grouping for pools have yet to be defined, but regional, asset, liability and philosophy bases have been discussed. The Board will have a central role in coordinating responses and analysis to support the proposals and the development of suitable proposals is a challenge for the room.

Q7. I would like to know if there are any particular plans for funds with low cost, outperforming internal investment teams.

A7. As above, the intention is for all LGPS assets to be pooled, there will not be exemptions for any fund. However, outperforming internal investment teams are well placed to work together to lead and influence the pooling proposals.

Q8. Has the option of negotiating an LGPS fee with external managers been considered without the need to pool funds? I understand that some managers are offering this already.

A8. As above, the policy intention would not be met by frameworks and/or procurement initiatives alone. A "keep doing what you're doing", "business as usual" option would not be acceptable to government.

Q9. Can it be confirmed if this issue/consultation includes Scotland or is it purely England & Wales.

A9. The consultation is for England and Wales, and the criteria setting will be carried out by DCLG. The regulations for the LGPS in Scotland are devolved, therefore Scotland is not included.

Q10. Some asset class mandates are restricted by capacity, for example, private equity. Are these sorts of asset class exempt from pooling?

A10. It is the intention that all asset classes would be included in pooling, including alternatives asset classes, property, private equity etc.

Q11. What are the timescales?

A11. Criteria should be available in the autumn, and government will expect a report on how work has moved forward by next March. A 'clear direction of travel' would be useful within the next six months. Proposals are expected to be realised within the lifetime of this parliament. It is recognised that this is a challenge – but Secretary of State has a preference for collaboration over prescription.

Q12. Will financial support be provided to help establish investment pooling infrastructure (i.e. setting up systems, processes and staff etc, not infrastructure as an asset class)?

A12. Funds will be expected to meet the costs of restructuring investments from their own budgets. As mentioned earlier, and in the knowledge that expenses will be considerable, the government is looking at a timescale longer than term of office for any cost savings to fully materialise.