

ITEM 4

London Borough of Enfield

REPORT TO:	Enfield Pension Board
SUBJECT:	Local Government Pension Scheme: Draft Statutory Guidance on Asset Pooling Consultation
LEAD OFFICERS:	Paul Reddaway

1. RECOMMENDATIONS

- 1.1. The Pension Board note the summary of the consultation which is set out in the text of this report. That the Board's views are sought as to the response.

2. EXECUTIVE SUMMARY

- 2.1. This report summarises the Ministry of Housing, Communities & Local Government (MHCLG) consultation on the Draft Statutory Guidance on Asset Pooling and suggests a number of issues to be addressed in the Council's response. There are no direct financial consequences to this report. However, issues around the investment of the assets of the Pension Fund will have direct financial implications for the Council.

3. DETAILS

- 3.1. The Ministry of Housing, Communities and Local Government issued, on 3rd January 2019, an informal consultation on the Draft Statutory Guidance on Asset Pooling. This consultation is open for 12 weeks and will close on 28th March 2019.
- 3.2. This report summarises the consultation, which is appended to this report as Appendix A. The consultation comprises seven sections. This report discusses each section in turn. Unlike formal consultations there are no questions for consultees to respond to, hence this report will describe the key points from each section and suggest a response.
- 3.3. The guidance sets out the requirements on administering authorities in relation to pooling assets and replaces the section at pages 7 to 8 of Part 2 of Guidance for Preparing and Maintaining an Investment Strategy, issued in September 2016 and revised in July 2017, which deals with regulation 7(2)(d) of the 2016

Regulations. It also replaces Local Government Pension Scheme: Investment Reform Criteria and Guidance, issued in November 2015.

4. Definitions

4.1. The consultation specifies a set of definitions for use in the current and future versions of the guidance. These are common sense definitions.

4.2. Structure and scale

4.3. This section reiterates the aims of pooling, that all administering authorities must pool their assets and that pool members must appoint a pool company or companies to implement their investment strategies, stating clearly, “It is for the pool companies to decide which investment managers to use for pool vehicles”. It also states that a pool company must be a company regulated by the FCA.

4.4. It is stated that Pool governance bodies, working with the Pool Company, “should regularly review the provision of services to the pool, and the process of procurement, to ensure value for money and cost transparency” and “the balance between active and passive management in the light of performance net of total costs. They should consider moving from active to passive management where active management has not generated better net performance over a reasonable period”.

4.5. Governance

4.6. The Consultation states that pool governance bodies must be established in order to “set the direction of the pool and hold the pool company to account” while pool members through their own governance arrangements will be “responsible for effective governance and for holding pool companies and other service providers to account”. In addition, “Strategic asset allocation remains the responsibility of pool members”. It also states Pension Committees should take a long term view of the potential benefits of pooling, taking into account “the benefits across the pool and across the scheme as a whole...and should not seek simply to minimise costs in the short term.” It also notes that Pension Boards can have a role in governance arrangements.

4.7. It also states that part of pool governance bodies’ role is to decide the pool’s policy on which aspects of asset allocation are “strategic” and which are “tactical”, with the guidance stating that, “governance bodies should be mindful of the trade off between greater choice and lower costs”. It is also noted that the position between what is deemed strategic and what is tactical is something that might change over time. It is also states that, “Pool members should set out in their FSS and ISS how they, through the pool governance body, have balanced these considerations and how they will keep this under regular review”.

4.8. Transition of Assets to the Pool

4.9. There are a number of comments on treatment of costs, including:

“Transition of listed assets should take place over a relatively short period.” And “...should seek to minimise transition costs to pool members while effectively balancing speed, cost and timing, taking into account exit or penalty costs and opportunities for crossing trades.” And “Inter-authority payments (or other transfers of value) may be desirable in order to share these costs equitably

between pool members. The Government's view is that such payments are investment costs within Regulation 4(5) of the 2016 Regulations, and payments made by a pool member to meet its agreed share of costs may be charged to the fund of that pool member, whether the payments are made to other pool members, the pool company, or another body by agreement."

- 4.10. It is noted that "In exceptional cases, some existing investments may be retained by pool members on a temporary basis" citing assets that need to be held to maturity as an example. It also notes that "Pool members may also retain existing direct property assets where these may be more effectively managed by pool members" and "...pool members may retain the management of existing long term investment contracts where the penalty for early exit or transfer of management would be significant. These may include life insurance contracts ('life funds') accessed by pool members for the purpose of passive equity investment, and some infrastructure investments."
- 4.11. For assets held outside the pool it is stated that, "Pool members, working with the pool company, should undertake regular reviews (at least every three years) of retained assets and the rationale for keeping these assets outside the pool."

4.12. Making New Investments Outside the Pool

- 4.13. There is an expectation that new investments will be made through the pool company with 2020 being set as the target timescale and a statement that "pool members should make new investments outside the pool only in very limited circumstances."
- 4.14. Exceptions (to pool members investing in their own pool) include, "A small proportion of a pool member's assets may be invested in local initiatives within the geographical area of the pool member or in products tailored to particular liabilities specific to that pool member", with clarity that Local assets should, "not normally exceed an aggregate 5% of the value of the pool member's assets at the point of investment and be subject to a similar assessment of risk, return and fit with investment strategy as any other investment."; or "may invest ...in a pool other than their own where collaboration across pools or specialism by pools can deliver improved net of fee returns".

4.15. Infrastructure Investment

- 4.16. There are a number of infrastructure related aspects noted in the document. Although supportive of the asset class, the consultation states, "There is no target for infrastructure investment for pool members or pools, but pool members are expected to set an ambition on investment in this area." "Government expects pool companies to provide the capability and capacity for pools over time to move towards levels of infrastructure investment similar to overseas pension funds of comparable aggregate size".
- 4.17. It is explicitly stated that Pools are expected to provide a range of options to accessing the asset class and may offer brown and greenfield exposure to the asset class. There is also comment that, "Pool members may invest in their own geographic areas but the asset selection and allocation decisions should normally be taken by the pool company in order to manage any potential conflicts of interest effectively, maintain propriety, and ensure robust evaluation of the case for investment". The consultation states for the purpose of annual

accounts CIPFA's definition for the asset class should be used (which includes a comment that conventional property is not normally included). The consultation also makes it clear that residential property is defined as infrastructure.

4.18. Reporting

- 4.19. There are a number of cost and pooling related requirements, including stating that, "Pool members are required to report total investment costs and performance against benchmarks publicly and transparently in their annual reports, following the CIPFA guidance: Preparing the Annual Report, with effect from the 2018-19 report."
- 4.20. The CIPFA guidance is also to be used when it comes to defining which assets are to be deemed pool assets, "pooled assets' are those for which implementation of the investment strategy – i.e. the selection, appointment, dismissal and variation of terms for the investment managers (including internal managers) – has been contractually, transferred to a third party out with the individual pension fund's control." Pool members should "provide a rationale for all assets continuing to be held outside the pool, including the planned end date and performance net of costs including a comparison which costs of any comparable pool vehicles. They should also set out a high level plan for transition of assets."
- 4.21. It is stated that the Scheme Advisory Board (SAB) will publish an annual report on the pools based on data from the pool member annual reports. It is also stated that pool companies should report in line with the SAB Code of Cost Transparency, with pool companies requiring their internal and external investment managers to do likewise. The final point on the consultation is to state that "Pool members are required to report any change which results in failure to meet the requirements of this guidance to the LGPS Scheme Advisory Board (SAB) and to MHCLG."

5. Consultation Response

- 5.1. Appendix 1 – sets out the London Borough of Enfield response (draft)

General Response

The Enfield Pension Fund welcomes the opportunity to respond to the draft statutory guidance on asset pooling. We are fully supportive of the pooling and the advantages in terms of potential for reduction in costs, increase in resilience of skilled investment staff and the opportunities it gives for investing in asset classes that we would not be possible on a standalone basis.

However, the guidance fails to take into consideration the wide variance of Pool Membership (3 to 32 Funds) and differing funding and maturity levels between Funds within each Pool. Within the London Pool there are 32 Funds comprising a wide range of investment styles, investment strategies, funding levels and cash flow positions.

The guidance is, therefore, too simplistic to be statutory as it fails to recognise the impact that strategic decisions made have on the local Council Tax Payer and therefore the degree of freedom that Committees of individual Funds require to mitigate those risks.

The idea that a Pool with a membership size of London could have a common policy on strategic and tactical asset allocation completely contradicts localism and accountability to local tax payer who will pick up any costs associated with poor decisions and if those decisions are made solely by the Pool Operator there is limited/no accountability.

If too much of the process is delegated to the Pool Operator there is a significant risk that offerings will be too generic to allow for differing attitudes to risk appetite, volatility, ESG considerations and individual share class currency decisions.

It is disappointing there is no guidance on ESG issues and how the Pooling Operator address the issues around responsible investments ensuring that there are products available

Specific response to individual sections.

Section 3 – As highlighted above it is too early to evidence whether the Pools will deliver on reducing costs. However, it is factually inaccurate to say that Funds **must** “Pool” their assets to achieve reductions in investment costs and increase transparency.

There is clear evidence that the creation of LGPS share classes with tiered fee rates can achieve the same outcomes without the additional administrative and regulatory costs of this being administered through a Pool.

Transparency can also be diluted through operating through a Pool rather than direct oversight as underlying Funds no longer have the automatic option of meeting with the Asset Manager as IMAs are between the Pool/Investment Manager and Pool/Fund. Therefore, if the intention is to increase transparency the guidelines need

to ensure that the Funds have the right to discuss and meet directly with the Investment Manager (This may require FCA approval).

Eliminating LGPS deficits and/or maintaining surpluses to the benefit of reduced employers' contributions will primarily be derived from strategic allocation and outperformance rather than fee reduction.

The comment that Funds "should consider moving from active to passive management where active management has not generated better net performance over a reasonable period" is over simplistic and fails to take account of the complicated funding challenges which LGPS administering authorities have to meet, particularly those that have past deficits to make up or who have negative cash flow and require investment income to meet pension payments.

The statement fails to acknowledge the weaknesses of investing to an index. For instance, an investment to passive bonds results in funds holding more bonds in the most indebted companies and while this might produce returns over the medium term a global recession might see these holdings losing the whole investment. Similarly, a fund investing in equities in order to gain index linked dividend returns would have received lower returns than a capital weighted index over the past 10 years but there has been no global recession in that time.

Finally, a fund may be looking at active management for income using the dividend income approach to enable funds to meet cashflows and liabilities in a risk controlled manner.

Paragraph 4.9 exposes the LGPS to unnecessary risk as Funds should not be restricted to asset classes within the Pool and then try to cobble together some mitigation in their Funding Strategy Statement. The Pool should be required to provide all asset classes that are needed to deliver the outcomes for its Members or the underlying Funds should be able to make alternative arrangements.

This paragraph implies that the Funds are there to comply with the Pool Operator (which is a contractor) and therefore goes against best practice. The Pool Operator should be there to meet the "reasonable" requirements of each and every fund and the guidelines should reflect this or allow for alternative arrangements to be made. If alternative arrangements are made the Secretary of State could chose to monitor these arrangements to provide an assessment on whether they deliver value for money.

To ensure that underlying Funds requirements are delivered pool companies and funds need more guidance on how they might achieve the correct blend of risk and return to enable funds within the pool to compromise on requirements that meets their Strategic Asset Allocation requirements. It is essential that the pool company is required to introduce contact points with pool members during the procurement process where the pool company liaises with pool funds over mandate requirements, the risks and returns that shortlisted managers are taking and what approach might lead to the best outcomes in terms of risk, return, cost and compromise for individual funds. Failure to follow a model like this will probably result in an outcome that reduces the optimum benefit from pooling.

We particularly welcome paragraph 6.3 however feel the guidance needs to be expanded as currently it could be viewed that this relates to just Infrastructure like assets. However, we believe this is not the intention as it is in the Government's and underlying Funds' interest to enable market forces to create Pools that become "best in class" and minimises the likelihood that any LGPS Fund would need to make any investment outside one of the 8 Pools. Pool companies will be stronger in different types of assets and specialist investment is more likely to deliver outperformance and optimise returns net of fees.

We recognise that pool companies are likely to want this provision removed from the guidance as it removes their monopoly on pooled funds and affects their business plans. However, we would urge the Government to resist these calls from pool companies as it would in our view damage scalability opportunities and be generally negative in removing an element of competitive pressure on pool companies. We would urge the Government confirms our interpretation of this paragraph and force pool companies to release a percentage of all their mandates to pool members from other funds. Thus introducing an element of competitiveness into what would otherwise be a monopoly market.