TOWER HAMLETS

Meeting of the

PENSIONS COMMITTEE

Tuesday, 25 February 2014 at 7.30 p.m.

A G E N D A

VENUE
COMMITTEE ROOM C1, 1ST FLOOR, TOWN HALL, MULBERRY PLACE, 5 CLOVE CRESCENT, LONDON E14 2BG

Members:	Deputies (if any):
Chair: Councillor Zenith Rahman Vice – Chair: Councillor Ann Jackson Councillor Judith Gardiner Councillor Craig Aston Councillor Oliur Rahman Frank West - Non-Voting Member (Trade Union) John Gray - Non-Voting Member (Admitted Body)	
[Note: The quorum for this body is 3 Members].	

Committee Services Contact:
Antonella Burgio, Democratic Services.
Tel: 020 7364 4881 E-mail: antonella.burgio@towerhamlets.gov.uk
Web: www.towerhamlets.gov.uk/committee

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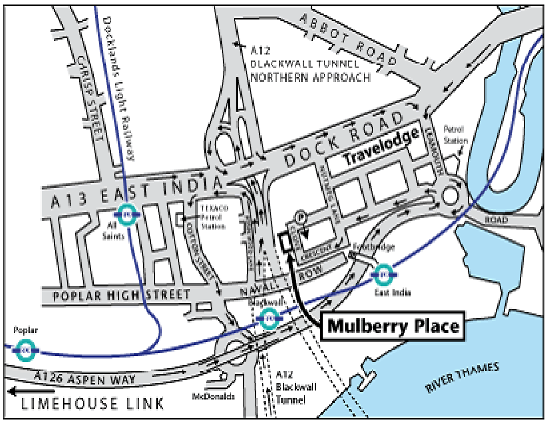

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LONDON BOROUGH OF TOWER HAMLETS

PENSIONS COMMITTEE

Tuesday, 25 February 2014

7.30 p.m.

3 .1 2013 Actuarial Review / Valuation (Pages 1 - 6)

To approve the finding of the Actuarial review and the arising recommendations from Hymans Robertson

3 .2 Report of Investment Panel for the Quarters Ending 30 September and 31 December 2013 (Pages 7 - 12)

To note the activities of the Investment Panel and the performance of the Fund and its investment managers for the two quarters ending 30th September 2013 and 31st December 2013.

4. INVESTMENT IN LONDON LGPS COMMON INVESTMENT VEHICLE (CIV) (Pages 13 - 50)

To receive a verbal update on the progress of CIV proposals

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TOWER HAMLETS

HYMANS ROBERTSON

London Borough of Tower Hamlets Pension Fund

2013 valuation results

- Barry McKay
- Fund Actuary
- 25 February 2014

1

HYMANS ROBERTSON
The Spirit of Independence

Why we do a valuation

- We have to!
- Assess how well pension promises are covered
- Monitor experience vs. assumptions
- Consider risks to the Fund & employers
- Balance affordability & risk
- **Set credible funding plans for employers**

Central part of risk management of the Fund

2

HYMANS ROBERTSON

Key assumptions for liability valuation

Assumption	2010 valuation	2013 valuation	Approach
Discount rate (assumed future investment return)	5.9%	4.6%	At 2010: gilts + 1.4% At 2013: gilts + 1.6%
Long term pay growth	5.3%	3.8%	At 2010: RPI + 1.5% At 2013: RPI + 0.5%
Short term pay restraint	1% for 3 years	Nil	At 2013: built into lower long term rate
Pension increases	3.3%	2.5%	At 2010: RPI – 0.5% At 2013: RPI – 0.8%
Longevity improvements		Increased allowance	

3

HYMANS ROBERTSON

Club Vita analysis

Specifically tailored to your fund

Source: Club Vita research based on VitaBank as at January 2013

4

HYMANS ROBERTSON

Impact of assumptions and experience

Key driver	Deficit	Contribution rate
Market conditions (net discount rate)	↑	↑
Investment returns	↓	↓
Life expectancy	↔	↔
New LGPS 2014	↔	↓
Overall Impact	↑	↑

Upward pressure on contributions

5

HYMANS ROBERTSON

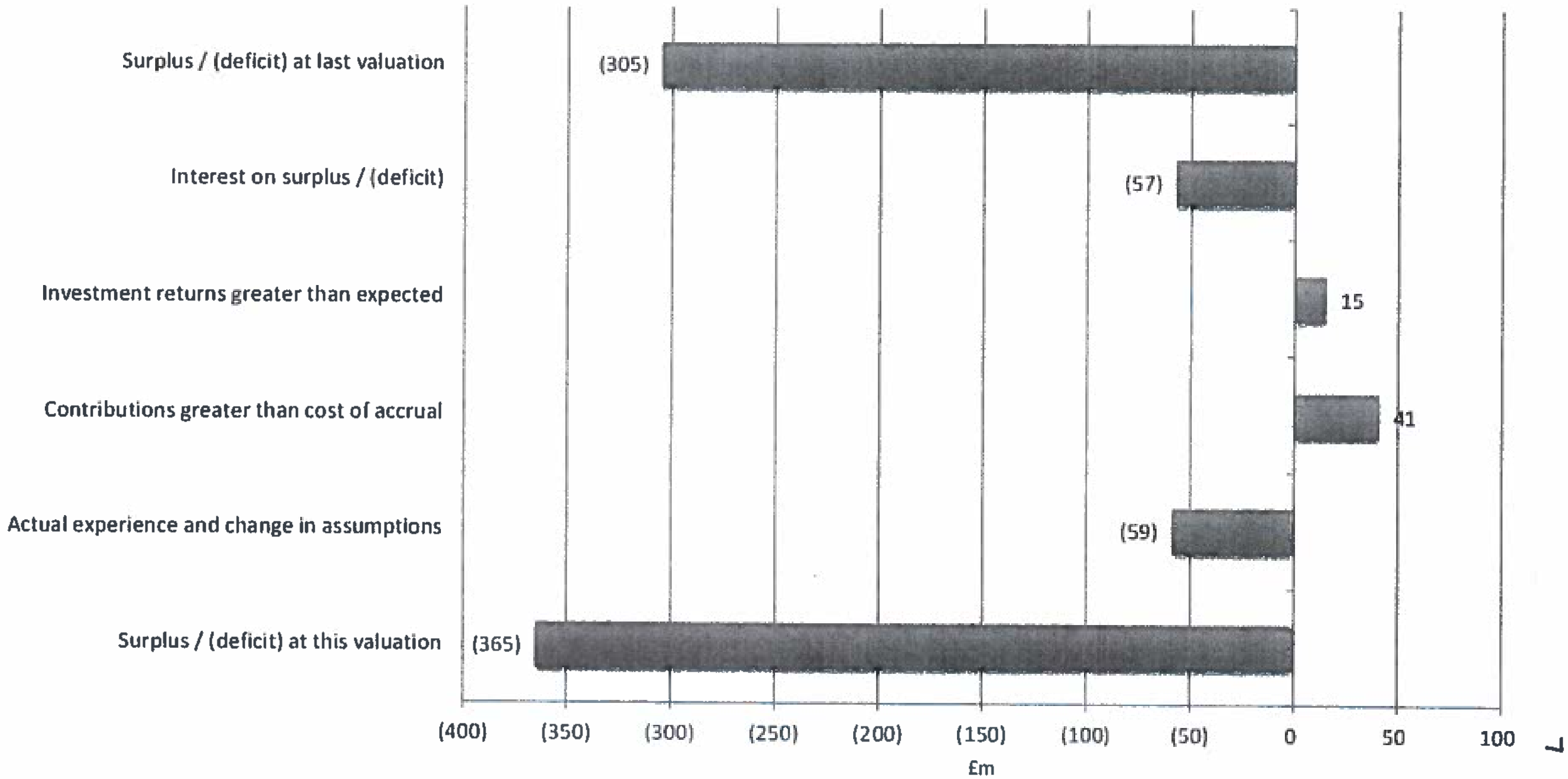
Whole Fund valuation results

Past Service Position	31 March 2010 (£m)	31 March 2013 (£m)
Past Service Liabilities	1,060	1,293
Market Value of Assets	755	928
Surplus / (Deficit)	(305)	(365)
Funding Level	71.2%	71.8%

Contribution Rates	31 March 2010 (% of pay)	31 March 2013 (% of pay)
Employer future service rate (incl. expenses)	17.3%	20.3%
Past Service Adjustment (20 year spread)	12.9%	15.2%
Total employer contribution rate (incl. expenses)	30.1%	35.5%
Employee contribution rate	6.8%	6.6%
Expenses	0.6%	0.7%

6

Experience since 2010



HYMANS ROBERTSON
The Spirit of Independence

New LGPS from 2014: funding impact

	Existing Scheme	Proposed New Scheme
Benefit Type	Final Salary	CARE with CPI revaluation
Accrual Rate	1/60th	1/49th
Retirement Age	65	State Pension Age
Member Contribution Rate	Average 6.5% Full-time equiv. pay	Average 6.5% Actual pay
Vesting Period	3 months	2 years

- Accrued rights protected (incl. retirement age, R85, final salary link)
- Existing scheme underpin for members within 10 years of NPA (age 65) at 1 April 2012 ("best of")
- Introduction of a "50/50" option to bolster LGPS participation
- "Cap and collar" cost control

8

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The Spirit of Independence

Next steps

- Contribution rates agreed with employers
- Contribution policy set out in Funding Strategy Statement
- Formal valuation report finalised by 31 March 2014

9

HYMANS ROBERTSON

Any questions

Hymans Robertson LLP and Hymans Robertson Financial Services LLP are authorised and regulated by the Financial Conduct Authority

10

6

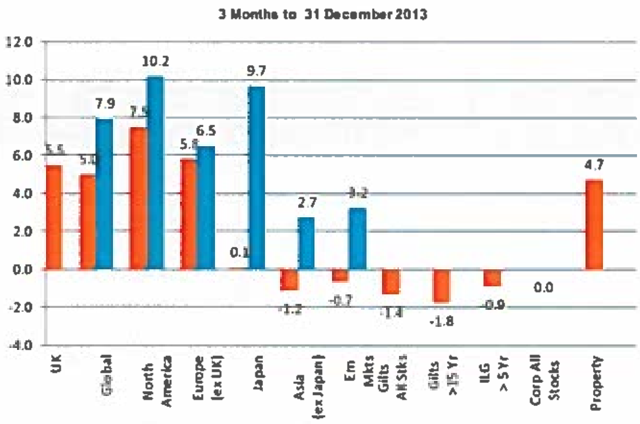
Market Background

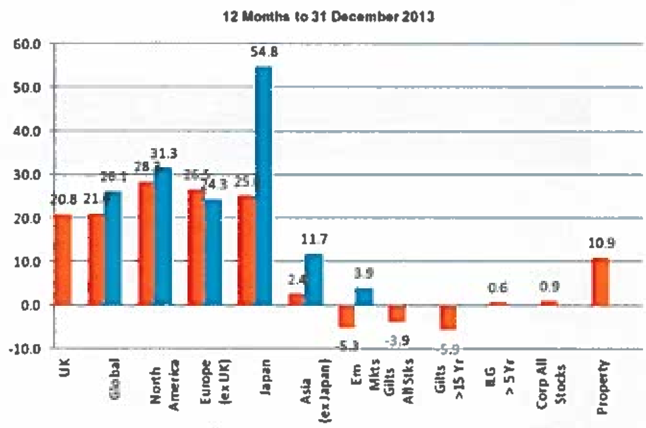
Introduction

This paper, addressed to the Officers and Advisers of the London Borough of Tower Hamlets Pension Fund ('the Fund'), discusses the market background over the fourth quarter of 2013 and subsequent events.

Market Background

The following charts show returns over periods to 31 December 2014:





Signs of the domestic and global economic recovery continued over the quarter, prompting the Bank of England to upgrade its economic forecast for the UK. Despite this, the Bank maintained that UK interest rates would remain unchanged in 2014. Meanwhile, further improvements in the US labour market led the Fed to announce it would begin tapering its quantitative easing programme from January 2014, although it reaffirmed a commitment to keep short-term interest rates low "well past" its 6.5% unemployment target.

Short-term interest rates in UK, US and Japan remained unchanged, while the ECB cut the Eurozone base rate from 0.5% to 0.25% as inflation fell below the Bank's 1% p.a. target.

Over the quarter, Sterling appreciated against the US Dollar, Euro and Yen. In Sterling terms, North America was the best region for equities (7.5%), followed by Europe ex-UK (5.8%) and the UK (5.5%). Returns on the Japanese market were buoyant at 9.7% over the quarter, but remained broadly flat in Sterling terms as the Yen continued to depreciate. The Emerging Market and Pacific ex-Japan regions lagged behind at -0.7% and -1.2% respectively.

Conventional and index-linked gilts struggled over the quarter as interest rates rose, returning -1.4% and -0.9% respectively. Corporate bonds benefited from narrowing spreads, with returns broadly flat.

Over 12 months, global equity markets have continued to deliver strong positive returns, with the exception of the Emerging Market regions which have lagged behind as fears over a reduction in capital investing led investors away. Rising interest rates over the last year have weighed heavily on bonds, with returns on conventional gilts pushed into negative territory and index-linked gilts and corporate bond markets struggling.

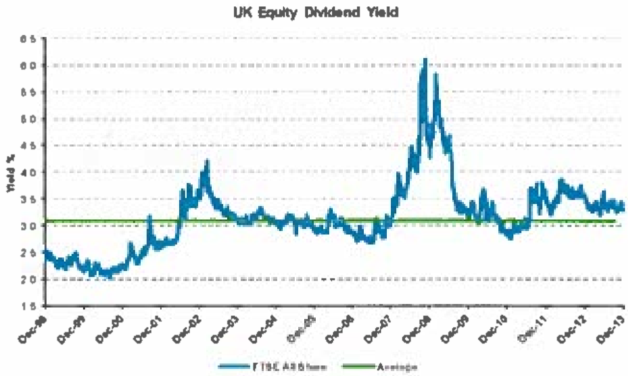
Property markets, represented by the IPD Monthly Property Index, were up by 4.7% since end September 2013 and by 10.9% over the last twelve months.

The tables below provide a summary of key financial indicators over recent periods:

	31.12.12	31.03.13	30.06.13	30.09.13	31.12.13
UK Equity yield	3.57	3.35	3.53	3.41	3.28
UK Equity P/E ratio	12.32	15.20	13.50	15.87	14.89
Over 15 year gilt yield (p.a.)	3.00	3.02	3.43	3.41	3.58
Over 5 year index linked gilt yield (p.a.)	-0.05	-0.41	-0.02	-0.02	0.05
iBoxx Over 10 year Non-gilt yield (p.a.)	4.14	4.13	4.62	4.48	4.61

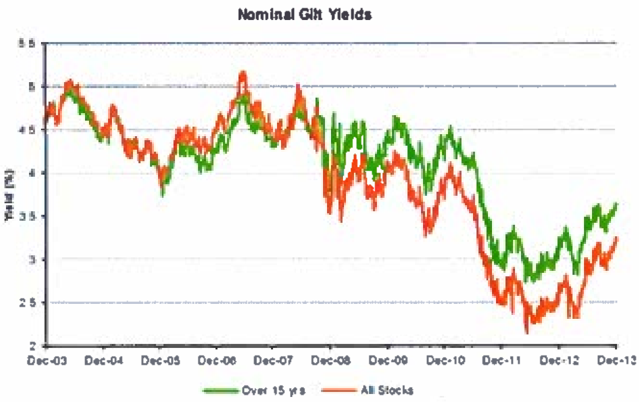
	Year to 31.12.09	Year to 31.12.10	Year to 31.12.11	Year to 31.12.12	Year to 31.12.13	Quarter to 31.12.13
FTSE All Share	30.1	14.5	-3.5	12.3	20.8	5.5%
Global Equity	21.2	16.7	-6.6	12.0	21.0	5.0%
Over 15 year gilts	-4.8	8.8	26.3	2.9	-5.9	-1.8%
Over 5 year index linked gilts	5.6	9.0	23.3	0.5	0.6	0.9%
All Stocks Non-Gilts	10.8	8.4	6.9	13.1	0.9	0.0%
IPD Monthly Index	2.2	14.5	8.1	2.4	10.9	4.7%

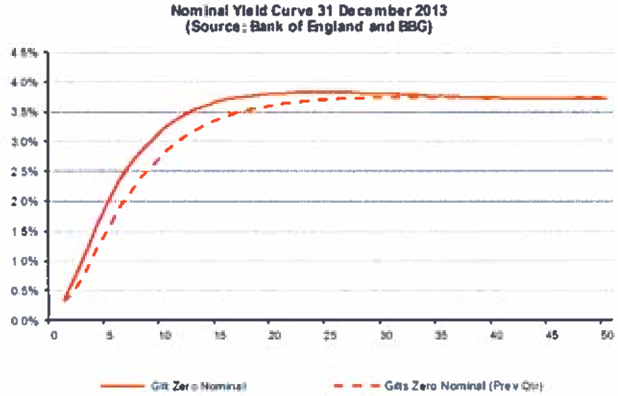
Equity Markets

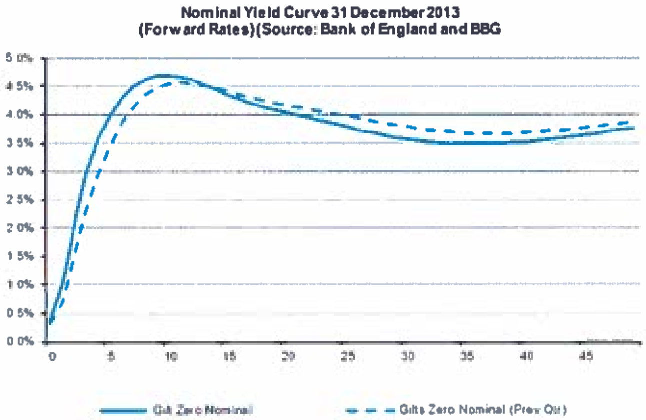


- In sterling terms, global equities were positive over Q4 (as measured by the FTSE All World index). The strongest returns came from North America (+7.5% in sterling terms). The weakest region was Pacific (ex, Japan) (-1.2% in sterling terms, but 2.7% when denominated in local currencies).
- In Sterling terms, Developed Markets outperformed Emerging Markets by 6.3% over the quarter. The pattern is similar over the last 12 months with Developed Markets having outperformed by approximately 31.4%.
- Despite the dividend yield remaining 20bps above the long-term average, the pace of growth in average dividends continues to slow, with growth over the last 6 months of only 1.9%.

UK Interest Rates

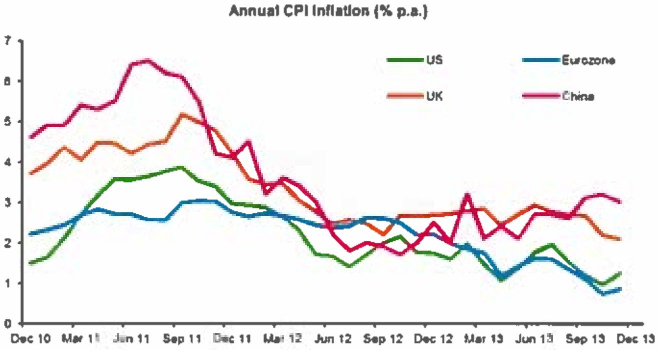




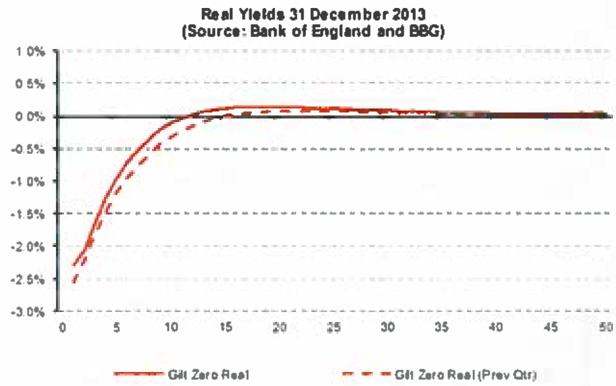


- Nominal gilt yields rose at all maturities below 40 years, beyond which there was a slight decrease.
- Markets continued to price in expectations of interest rate rises, with forward rates reaching 4% p.a. in 5 years' time (down from over 6 years) and implying a return to 'normalised' levels over between 5 and 10 years.

Inflation and Real Rates

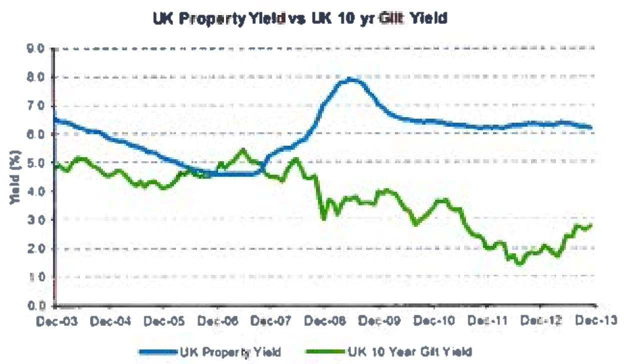


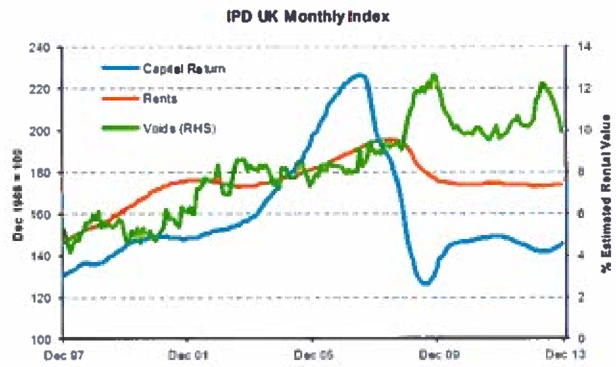
- Global inflationary pressures remained somewhat subdued over the quarter. In the US and Eurozone, inflation remains under the 2% p.a. target, with a further drop in Eurozone inflation to below 1.0% prompting the European Central Bank to cut interest rates in November.
- UK inflation fell to 2.0% in December, bringing it in line with the Bank of England's target for the first time since November 2009. RPI remains higher at 2.7%, still materially lower than long-term inflation protection which remains priced well over 3.5% p.a.



- The UK's long-term inflationary outlook was virtually unchanged over the quarter, having been largely stable over the last year.
- At maturities below 25 years, real gilt yields rose over the quarter in response to rising gilt yields and relatively stable implied inflation.
- Real gilt yields are now positive at durations above 12 years, although swap yields remain negative at all maturities.

UK Property





- UK property delivered a return of 4.7% over the quarter as capital values continued to rise. For the first time since June 2010, capital growth became the driver of returns, with capital growth outstripping income by around 1.3% over the quarter (capital values increased by 3.0% over the quarter, while income remained steady at around 1.7%).
- Void levels fell during the three months to end December, with the most noticeable changes in the office and industrial sectors.

Prepared by:-

Matt Woodman, Investment Consultant

For and on behalf of Hymans Robertson LLP

General Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.

COMMITTEE:	DATE:	CLASSIFICATION:	REPORT NO.
Pensions Committee	**25 February2014**	**Unrestricted Report** **Restricted Appendix**	

REPORT OF:	TITLE:
Interim Corporate Director of Resources ORIGINATING OFFICER(S): Kevin Miles – Chief Accountant	**Investment in London LGPS Common Investment Vehicle** Ward(s) affected: N/A

Community Plan Theme	**All**
Strategic Priority	**One Tower Hamlets**

APPENDIX - NOT FOR PUBLICATION

The Sub-Committee may by resolution exclude the public from the meeting during anitem of business where it is likely, in view of the nature of the business, that there wouldbe disclosure of exempt information as defined in Section 100I and Schedule 12A of theLocal Government Act 1972. To be exempt, information must fall within one of thecategories listed in paragraphs 1 to 7 of Schedule 12A, must not fall within one of theexcluded categories in paragraphs 8 and 9 and the public interest in maintaining theexemption must outweigh the public interest in disclosing the information.
This report contains information falling within paragraphs 4 and 5 of Schedule 12A - "Information relating to any consultations or negotiations or contemplated consultationsor negotiations, in connections with any labour relations matters arising between theauthority, or a Minister of the Crown and employees of, or office holders, under theauthority"; and "Information in respect of which a claim to legal professional privilegecould be maintained in legal proceedings." There is a public interest favouring publicaccess to local authority meetings reflected in the provisions of PartVA of the 1972 Act.Public access promotes accountability, transparency and public involvement. In thiscase however, the report contains information relating to consultations or negotiations inrespect of the recruitment of the post of Chief Executive. The Committee may take theview that the public interest in maintaining the exemption on the information outweighsthe public interest in disclosing it.

Note - Further legal advice was taken on the nature of the documents to be discussed as a result of which the contents and appendix of the report were considered to be suitable of discussion in open session. Accordingly the documents have been made available as a supplement

1. SUMMARY

1.1 In an attempt to reduce pension fund administration costs, the creation of a London wide common investment vehicle is being created through London Councils. The fund would allow pension fund investments to be pooled for the purpose of reducing fund manager's fees as a lower fee is charged the larger the investment.

1.2 At the moment, the scheme is in its early stages of development. This report is to ask the Pensions Committee for approval to participate in the scheme – an initial capital investment of £1 is required at this stage to register interest. However this does not commit the Council to any future investment but would enable the Council to be involved in the development of the concept.

1.3 Before any major policy change takes place in relation to investment through this medium, Full Council authority will be sought for approval of the principle and any decisions to transfer pension fund investments to the Common Investment Vehicle would need to be approved by this committee. The investments available in the Investment Vehicle would need to match the council's investment strategy.

2. DECISIONS REQUIRED

2.1 The Committee is recommended to agree that the Pension Committee of the London Borough of Tower Hamlets pension scheme become a shareholder in the ACS Operator

2.2 Agree that the fund invests £1 to the ACS Operator as initial capital.

3. REASONS FOR DECISIONS

3.1 The proposal provides the potential to take advantage of lower investment management fees thereby achieving a saving to the pension fund. By becoming a shareholder from the inception the Council would be able to participate in the development of the project but without any long term commitment to invest which would necessitate further decisions once the methodology has been agreed.

4. ALTERNATIVE OPTIONS

4.1 The theory of the CIV is that fund managers will charge a lower management fee on pooled investments managed. If the CIV investment proves to be a popular fund, then if the Tower Hamlets fund was outside the scheme it would not have the potential to benefit from economies of scale.

5. BACKGROUND

5.1 A joint London Borough Pension Working Group initiative is looking at ways in which pension schemes can work together to get financial benefits and efficiencies of scale from joint working.

5.2 A pensions working group led by London Councils is proposing to launch a common investment vehicle to enable London Boroughs to participate in a scheme of joint pension fund investing. It will be an Authorised Contractual Scheme (ACS). This scheme will have FCA (Financial Conduct Authority) approval. It is currently planned that the scheme will be launched in February 2015, though this date may slip to later in 2015. Details of the proposed scheme are shown in the attached London Councils report.

5.3 This work is partly in response to the Government's review of Local Government Pension Schemes. Further Government announcements may be made to request more joint working by councils to reduce administration costs.

5.4 If Tower Hamlets Council invests £1 capital in the scheme, then it will have the option of joining the ACS Common Investment Vehicle if the investments available are in line with the pension investment strategy and will offer reduced costs to the fund.

5.5 In theory, the Council could move an unlimited amount of its investments into the scheme if they were in line with the investment strategy and offered reduced fees. The Council pension scheme has around £1 billion of investments with annual management fees total around £2.3 million. Investments within the fund are likely to be unitised fund type investments.

5.6 **Pension Committee will need to approve membership of the ACS and will be asked to approve an initial investment of £1 at this stage to register an interest in participating. There is no further obligation to participate or invest at this stage**.

5.7 To maximise the value of pension schemes, ways to reduce the volume of management fees charged to pension schemes are being explored. This Common Investment Vehicle approach has been designed by London Councils as a way in which similar investment types within different London Boroughs can be combined to benefit from smaller fee charges. Fund manager's fees are based on the size of the fund and are based on a percentage of the amount managed. The larger the fund, the lower the percentage fee charged.

6 CURRENT LONDON BOROUGH PENSIONS SCHEMES

6.1 At present each London Borough has its own pension scheme. Each scheme will be managed by its own Pension Committee and will have a range of investments intended to provide a sufficient return to meet pension liabilities. All schemes will have similar, but not identical range of investments.

6.2 All schemes are likely to have investments in equities (UK and overseas), property and bonds. Some schemes may have more alternative investments such as private equity, infrastructure or hedge funds.

6.3 The Tower Hamlets pension scheme invests in equities, property, bonds, Gilts and growth funds (these can invest in a range of investments with the aim of achieving a higher return). Passive, tracker managers who track share indices, such as Legal & General are used. Active managers, such as Baillie Gifford and GMO are used with the intention of outperforming stock market index movements. Active managers charge higher fees than passive managers.

6.4 Manager fee structures – fees are based on a percentage of the amount of the funds invested. As the amount invested increased, managers usually charge a lower fee percentage. This should also apply to custodian costs of holding the investments securely.

6.5 As a number of councils use the same pension fund managers, then the combination of investments will mean the lower fee thresholds will be exceeded, thus reducing the fees payable. It is the saving of these fees and in theory, the appointment of high performing managers that should provide a financial advantage for the council's pension fund from using the ACS. The Council paid fund management fees of around £2.3 million in 2012/13

7. ACS PROPOSALS

7.1 The scheme has a minimum target investment size of £5bn across all investors; though it is hoped investments will be significantly higher. 31 of the 33 London Boroughs have expressed an initial interest in the scheme.

7.2 A new Pensions CIV Joint Committee will be established under the London Councils arrangements and will oversee the ACS operator. Participating councils will appoint members and officers to the Joint Committee. The proposed structure is shown in paragraph 11 of the appendix.

7.3 The creators of the ACS have been liaising with a number of investment managers to see if they will be likely to participate. At this stage a number of managers have expressed an interest including some who do not have many local authority clients. If managers believe there is more chance of obtaining or keeping business by being in the ACS (even at a lower fee level), then the scheme should be successful.

7.4 Though there will be further costs of setting up and managing the scheme, the management fee savings are expected to be around double those of running the scheme. Please refer to paragraph 43 of the progress report attached to see details of the costs and potential savings.

8. INVESTMENT IN THE ACS COMMON INVESTMENT VEHICLE

8.1 To take part in the ACS Common Investment Vehicle, each London Borough will be asked to buy a £1 share in the fund. Those Boroughs that participate in the scheme will then be asked to contribute an equal share of £100,000 of initial capital (i.e. if there are 10 initial investors including LBTH, the contribution will be £10,000).

8.2 Once investments are placed in the fund, the OCS Operator will require further capital of 2 to 3 basis points (0.02%-0.03%) of the sums invested. For example if the council invested £100million in the scheme, the additional capital investment would be £40,000. This £40,000 would be funded from the transfer of existing pension fund Gilt investments into the fund. This investment requirement by scheme operators is common to investment schemes of this type.

8.3 LBTH has already contributed £20,000 to initial set up costs of the scheme to get the proposals to this stage of development.

8.4 At present, we don't know what fund managers will be participating in the scheme. Until more details are available, no further investment other than the initial £1 investment will be required. If the investment options available in the ACS don't suit the needs of the LBTH pension fund, then the council is under no obligation to participate further. Most of the fund managers the council employs have been performing above average over the last year.

8.5 Once the ACS is operational, it is likely that the first group of investments available will include tracking funds that simply perform in line with share indices, such as the FTSE. These funds are bought and sold in units and have the lowest management fees. If the council wishes to hold non-standard investments, then these will probably remain outside the ACS. It should be noted that the standard nature of ACS investments could limit the council from involvement in investment decisions as the managers will manage funds from the perspective of all investors.

8.6 If the council's existing managers opt to take part in the ACS, then there may be potential to move the council's investments into the ACS to obtain lower fees with minimal administrative work.

8.7 The scheme will have an appointed custodian to hold the investments. Though the council's investments will be combined with other council's investments to achieve volume savings, LBTH's share of investments will need to be clearly identifiable. The council will need to be able to see its investments when needed to pay pensions due.

8.8 Before placing pension fund investments in the ACS, legal approval for this investment will be needed. The scheme organisers have been taking legal advice throughout the development stages

9. COMMENTS OF THE CHIEF FINANCIAL OFFICER

9.1. The comments of the Corporate Director Resources have been incorporated into the report.

10. LEGAL COMMENTS

10.1 Regulation 11(3) of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 requires the Council, as an administering authority, to invest fund money that is not needed immediately to make payments from the Pensions Fund. Regulation 11(1) requires the Council to have a policy in relation to its investments. The investment policy must be formulated with a view –

(a) to the advisability of investing money in a wide variety of investments; and

(b) to the suitability of particular investments and types of investments. The Council is also required to have a Statement of Investment Principles in accordance with regulation 12 (1) which cover the following matters:

(a) the types of investment to be held;

(b) the balance between different types of investments;

(c) risk, including the ways in which risks are to be measured and managed;

(d) the expected return on investments;

(e) the realisation of investments;

(f) the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments;

(g) the exercise of the rights (including voting rights) attaching to investments, if the authority has any such policy; and

(h) stock lending.

In accordance with Regulation 11(5), The Council is required to take proper advice at reasonable intervals about its investments and must consider such advice when taking any steps in relation to its investments.

10.2 It is desirable for the Council to take steps to reduce the costs of administering its pension fund. The proposal to create a Common Investment Vehicle appears to be viable way to achieve savings.

10.3 Pursuant to the above duties and powers the Council has capacity to explore and develop a methodology for a more efficient and effective means of investing pension fund assets. These proposals do not commit the Council to more than the nominal sum of £1 to join the consortium of London Boroughs and if, at the end of the development phase, it appears to be worthwhile for the Council to invest through this mechanism, a further report will be required.

10.4 Lawyers for the Boroughs are collaborating to ensure that advice given to their authorities is consistent and appropriate. Legal Services will engage with colleagues from the other participating Boroughs to ensure that the best possible advice is given to this Committee and the Council.

10.5 There are no immediate legal implications arising from this report though legal considerations will arise in the course of the development of the arrangements which will be addressed appropriately as and when required.

11. ONE TOWER HAMLETS CONSIDERATIONS

11.1 The employer's contribution is a significant element of the Council's budget and consequently any improvement in investment performance or reduction in management fees will reduce the contribution and increase the funds available for other corporate priorities.

11.2 A viable pension scheme also represents an asset for the recruitment and retention of staff to deliver services to the residents.

12. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

12.1 There is no Sustainable Action for A Greener Environment implication arising from this report.

13. RISK MANAGEMENT IMPLICATIONS

13.1 Any form of investment inevitably involves a degree of risk.

13.2 To minimise risk the Investment Panel attempts to achieve a diversified portfolio. Diversification relates to asset classes and management styles.

14. CRIME AND DISORDER REDUCTION IMPLICATIONS

14.1 There are no crime and disorder reduction implications arising from this report.

15. EFFICIENCY STATEMENT

15.1 The monitoring arrangement for the Pension Fund and the work of the Pension Fund Investment Panel should ensure that the Fund optimises the use of its resources in achieving the best returns for the Council and members of the Fund.

LOCAL GOVERNMENT ACT 1972 (AS AMENDED) SECTION 100D

LIST OF "BACKGROUND PAPERS" USED IN THE PREPARATION OF THIS REPORT

Brief description of "background papers"	***Name and telephone number of holder And address where open to inspection***
CIV investment presentation slides	

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Leaders' Committee

Pensions Working Group: Progress report, business case, and proposed next steps towards a London LGPS CIV

Item no: 7

Report by:	Hugh Grover	**Job title:**	Director, Fair Funding, Performance and Procurement
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Summary

This report follows on from previous discussions, in particular at Leaders' Committee throughout 2012, and in May and December of 2013, and discussions at the Executive in September and November 2013. Those discussions have focussed on the potential for more collaboration between boroughs that wished to do so, on the management and investment of pension funds.

In response to the report presented to Leaders' Committee in December 2013, London Councils has engaged expert legal and financial services advisors to develop a robust business case and formal proposal to inform decisions for implementation of a London LGPS Collective Investment Vehicle (CIV), in the form of a UK based, Financial Conduct Authority (FCA) Authorised Contractual Scheme (ACS).

This report which reflects the views and advice of the advisers, in consultation with London Councils' legal advisors from the City of London Corporation, fulfils that request. It sets out the current thinking of the Pensions Working Group (PWG) and asks Leaders' Committee to recommend to the boroughs that they proceed to establish an Authorised Contractual Scheme (ACS) and the ACS Operator (which is the company that would manage the ACS)

It should be noted that, all the proposals outlined in this report are based on voluntary participation by boroughs, and the decision as to whether to invest in the ACS would be made by individual boroughs later in the year. There is nothing proposed in the report that locks any borough into any level of commitment to invest.

Dialogue with HM Government relating to the Government's review of Local Government Pension Schemes is ongoing, and it is apprised of the progress made to date by London Councils and the PWG. At the time of writing the report, we still await the Government announcement on their proposed direction of travel.

This report provides an overview of the proposals and recommendations, Annex A provides Elected members with the underlying detail.

Recommendations Leaders' Committee is asked to:

1. Consider the report and the underlying business case supporting the establishment of a collective investment vehicle, in the form of an authorised contractual scheme (the "ACS"), for local authority pensions in London ("the Arrangements"); AND
2. Endorse and recommend to each local authority which decides to participate that, they resolve that:
   - (a) a private company limited by shares be incorporated to be the Authorised Contractual Scheme Operator (the "ACS Operator"), structured and governed as outlined in this report, and that the local authority agrees –
     - (i) to become a shareholder in the ACS Operator, and
     - (ii) to contribute £1 to the ACS Operator as initial capital, and
     - (iii) to appoint an elected Councillor who will have power to act for the local authority in exercising its rights as a shareholder of the ACS Operator, and
     - (iv) that Mayor Pipe, Councillors O'Neill and Dombey, Mr Chris Bilsland (Chamberlain, City of London), Mr Chris Buss (Finance Director, LB Wandsworth), Mr Ian Williams (Finance Director, LB Hackney), and Mr John O'Brien (Chief Executive, London Councils) be appointed as the interim Directors of the ACS Operator, subject to the consent of their relevant authorities to the appointments. These directors may be replaced once FCA authorisation is formally applied for; and
   - (b) a representative body, in the form of a new sectoral joint committee (the "Pensions CIV Joint Committee"), is established (pursuant to the existing London Councils Governing Agreement, dated 13 December 2001 (as amended)) to act as a representative body for those local authorities that resolve, in accordance with 2(a) above, to participate in the Arrangement (or in the alternative, should all 33 London authorities resolve to participate, that Leaders' Committee exercise these functions and the Governing Agreement be varied accordingly); and
   - (c) All London local authorities respond in writing to the London Councils Chief Executive, by 14 April 2014, or before the day of the local government elections (22 May 2014), to advise of their decisions regarding the matters set out at paragraphs 2(a) and 2(b) above.

Pensions Working Group: Progress report and proposed next steps towards a London LGPS CIV

Introduction

1. At its December 2013 meeting, Leaders' Committee received a progress update from the Pensions Working Group (PWG), which outlined the views and recommendations of the PWG in respect of the potential London LGPS Collective Investment Vehicle (CIV). Leaders' Committee agreed the recommendations of the PWG that a business case and formal proposal should be prepared to inform decisions for implementation of a CIV which should be structured as a UK based, Financial Conduct Authority (FCA) Authorised Contractual Scheme (ACS). This report sets out the proposed business case, and formal proposal as to how to proceed. Leaders' Committee is asked to endorse the formal proposal for the formation of the ACS and its Operator, and to recommend the proposal to their own Council.

2. This paper recaps the financial benefits which may arise from operating an ACS, and sets out further details of the expected costs. It also sets out further details of the proposed structure of the ACS and potential governance arrangements (including the ACS Operator), together with the steps that are required to progress the project and establish the ACS and its Operator. This is set out in detail in Annex A, which should be read in conjunction with this report. The decision as to whether to invest in the ACS, once established, will remain with each Borough Pensions Committee and is distinct from the decision which is now being recommended to establish a new Pensions CIV Joint Committee and the Operator of the ACS. Any decisions regarding investment in the ACS will not begin until later in the year and are likely to be on an asset class by asset class basis.

Background

3. In 2012, a report from PwC set out options for reconfiguring the London LGPS funds, and indicated the possible financial benefits of a CIV. Since then, the matter has been discussed several times, and it was agreed that further consideration should be given to creating a CIV, and that the most appropriate structure for the CIV would be an ACS. A number of the local authorities agreed to contribute £25-£50k towards exploring the proposal which are held in a designated fund by London Councils. These contributions will fund the professional costs associated with development of the proposed ACS and its Operator.

4. The Government issued a call for evidence on the future structure of the LGPS last year, and sought professional advice to consider either Collective Investment Vehicles or merger of funds as potential routes forward. This advice, being provided by Hymans Robertson, and the Government consultation are expected to be published shortly. However, it is unlikely that this will be ahead of Leaders' Committee meeting. Nonetheless, informal indications are that, while undoubtedly Leaders' Committee position will need to be considered in the light of whatever is published, it seems unlikely that the benefit of CIVs will be fundamentally challenged.

5. At its December 2013 meeting, Leaders' Committee resolved to engage expert legal and financial services advisors to assist in the development of the ACS and its Operator. These advisors, along with a Custodian advisor, have been appointed and over recent weeks further analysis has been undertaken on the legal, regulatory, and financial aspects of implementing the CIV, in consultation with City of London lawyers who are London Councils' general legal advisors. The Leaders' Committee asked the PWG, having regard to that specialist advice, to develop a robust business case and formal proposal to proceed with implementation of the ACS to inform Boroughs' decisions, and this is set out in the sections which follow.

Proposed structure

6. It was previously agreed that the most appropriate structure for the CIV is an ACS fund and nothing has emerged to suggest that that recommendation should change. The ACS will require an FCA regulated ACS Operator to be established. The board of directors and employees of this company will have overall responsibility for the operation of the ACS.

7. In considering the proposed structure of the ACS and its Operator, the PWG has sought to adhere to the following overarching principles, in order that the arrangement can best meet the requirements of the boroughs:

   a) Investment in the ACS should be voluntary. A borough should be able to decide it does not wish to participate, or to the extent it initially decided to participate, to choose to withdraw its investment.

   b) If a borough chose to invest, it will be able to choose which asset classes to invest into, and how much it might invest into each asset class.

   c) The boroughs should have sufficient control over the ACS Operator, in order to be assured that it will be acting in their best interests.

   d) The ACS Operator would provide regular information to participating boroughs regarding the performance of managers, investment options, and other areas, so that information continues to be available to the same extent it is currently in order for boroughs to make investment decisions.

   e) Authorities seeking to invest in the ACS will also take a shareholding interest in the Operator (and have membership of the Pensions CIV Joint Committee).

   f) The ACS will not increase the overall investment risk faced by boroughs.

8. The ownership structure and process for governance and decision making of the ACS Operator has been considered in some detail and is set out in the diagram below. The analysis contained in this paper including the Annex is a summary of the key issues associated with the establishment of the structure. Additional detail including in particular legal and regulatory analysis will be required in due course as the project progresses.

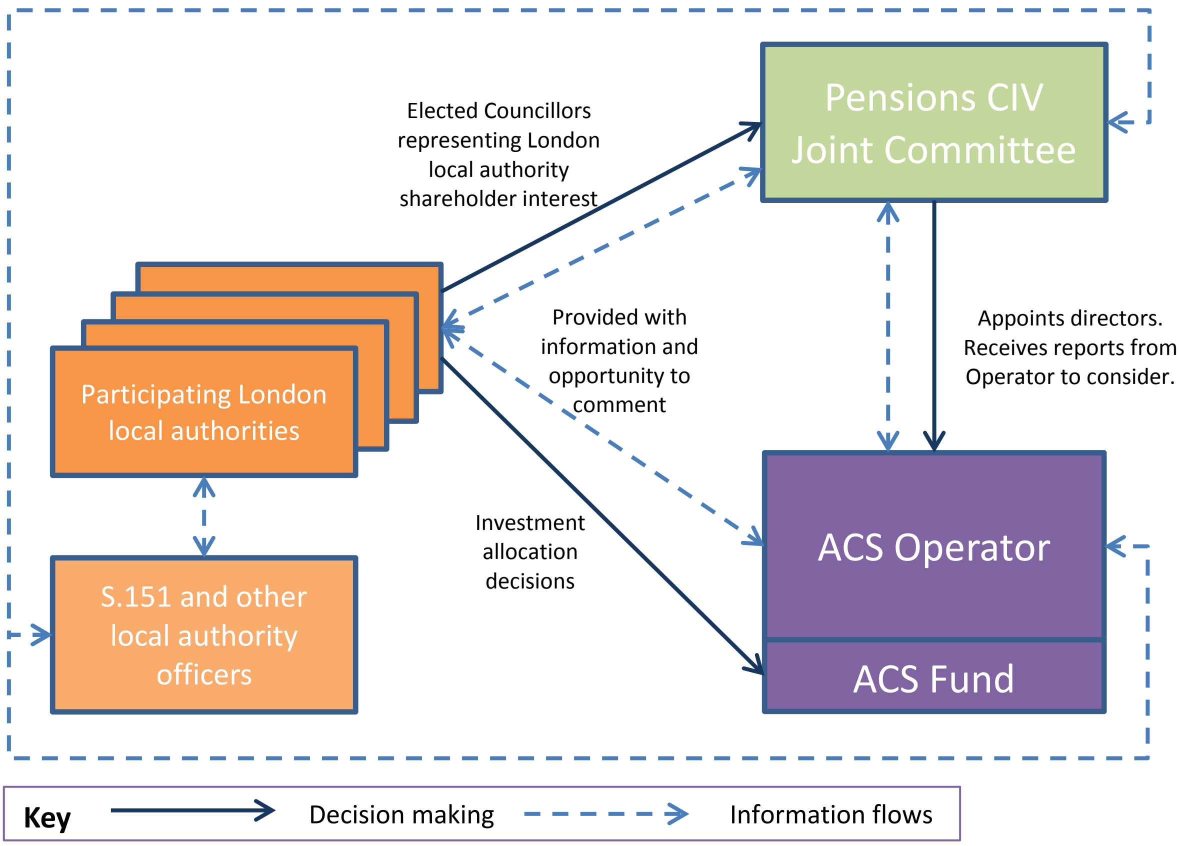
9. In broad terms, the proposed structure is that the boroughs will own all the share capital of the ACS Operator. Initially this will require minimal share capital (£1 per borough) but this capital requirement will increase once the operator is authorised and investments

are made in the ACS. The capital requirements are considered in more detail below (see paragraphs 14-18).

10. A new 'Pensions CIV Joint Committee' will be established under the existing London Councils arrangements to assist in the appointment of directors to the ACS Operator. The Pensions CIV Joint Committee will comprise elected Councillors nominated by participating boroughs as provided for under the existing London Councils Governing Agreement. Information will be provided regularly by the ACS and the ACS Operator to local authorities investing, and their Pension Committees and officers, and the Pensions CIV Joint Committee. Borough treasurers will provide advice to both the borough Pension Committees (as they do now) and to their authority's representative on the Pensions CIV Joint Committee.

11. The governance arrangements and lines of communication between various interested parties are illustrated in the diagram below.

Fig 1 – CIV governance and communication lines



12. The proposed structure has been designed to allow boroughs to have strong oversight and control over the ACS Operator. This oversight and control is achieved at a number of levels including the following:

a) The boroughs will own all the shares in the ACS Operator and will be able to exert influence over the ACS Operator's board and activities through their shareholdings;

b) The ‘Pensions CIV Joint Committee’ will be made up of elected Councillors nominated by their boroughs. This Joint Committee will represent and assist the boroughs having a shareholding in the ACS and will have the power to identify and appoint key directors to the ACS Operator. It would also be a forum to discuss key issues which affect the participating local authorities, both individually and collectively;

c) Subject to regulatory requirements, the board of directors of the ACS Operator is likely to include some representatives of the shareholders of the ACS Operator (expected to be appointed from the elected Councillors who will sit on the Pensions CIV Joint Committee and who will represent all participating local authorities’ interests);

d) The ACS operator will require staff (on a part-time basis) to assist in activities including investment manager selection and it is proposed that as many of these roles as possible may be undertaken by existing elected Councillors and officers of boroughs with relevant experience; and

e) Information relating to the performance of investments and the ACS Operator will be made available on a regular basis to boroughs investing and the Pensions CIV Joint Committee representing the boroughs’ shareholding interest in the Operator.

13. Should boroughs be minded to proceed with establishing the ACS Operator, at this stage the company can be established with interim directors, with formal appointments for the ongoing directors made in the autumn, prior to FCA approval.

Capital requirements of the ACS Operator

14. Initially the ACS Operator will only require minimal share capital and, as such, it is recommended that each borough that wishes to proceed will acquire £1 of share capital in the company.

15. Immediately before the ACS Operator receives regulatory approval (expected to be 4th quarter 2014 or 1st quarter 2015), it will require capital of c£100,000. It is proposed that this capital would be contributed by those boroughs who choose to move forward with the ACS in Autumn – so for example if 10 boroughs decided to proceed with the ACS in Autumn, this would require a capital contribution of £10,000 per borough.

16. Once the ACS starts receiving investments, it will require additional capital. It is proposed that boroughs who invest pension assets in the ACS, would contribute capital to the ACS Operator in proportion to the assets invested, expected to be c.2 to 3 basis points of assets invested (e.g. for £5bn of assets invested in the ACS, the ACS Operator would require capital of £1m to £1.5m). It should be noted that this contribution is an investment rather than an expense as this capital would be invested in liquid assets such as gilts rather than being used to pay expenses.

17. It should be noted that this contribution is an investment rather than an expense as this capital would be invested in liquid assets such as guilts rather than being used to pay expenses. It is not expected that this should materially impact any return to the boroughs as the funds invested could be from existing pension assets which are currently invested in gilts or similar investments. As such the borough fund could retain

exactly the same investment profile except that a very small proportion of its assets invested via gilts would be held indirectly through the ACS Operator rather than directly as at present.

18. It should be noted that boroughs who contribute £1 of share capital now will be under no obligation to make any further capital payments to the ACS operator. To the extent a borough takes a subsequent decision to invest in the ACS, it is proposed the borough would at that point invest further capital. (see paragraph 15).

Financial case

19. Previous work undertaken by PwC estimated savings in the region of £120m per annum from the creation of a CIV (the ACS), provided there was close to full participation by the 33 London local authorities. These benefits arose from reduced investment management fees, and improved performance. Costs of running the ACS were estimated to be £4.8m if there was full participation from all the authorities. At lower levels of participation, both the financial benefits and the costs would reduce.

20. More work has now been undertaken on potential costs and benefits, based on high level assumptions, and these are summarised in the table below. Additional details on the savings and costs are set out at Annex A. It is clear that, based on the expected savings previously identified, forecast costs should be comfortably covered by savings in reduced management fees.

Fig 2 - Summary of savings and costs

	Assets under management £24bn **£ 000's**	**Assets under management £10bn** **£000's**	**Assets under management £5bn** **£ 000's**
Expected savings per annum	120,000	50,000	25,000
On-going Costs per annum	(6,100)	(3,650)	(2,750)
Establishment Costs	(1,700)	(1,500)	(1,400)

21. Savings and costs have been analysed for assets under management of £24bn, £10bn and £5bn. It is considered that a reasonable minimum target size of assets under management for the ACS is in the range of £5bn. This is based on analysis of existing investments held by LGPF funds undertaken by the PWG and also takes into account that initially the majority of investment mandates are likely to be passive mandates. Over time, it is expected that active mandates and investments into alternatives such as property and some infrastructure assets may be added to the range of investments offered by the ACS.

22. Even at a level of assets under management of £5bn, the expected savings materially outweigh the expected costs. The actual savings and costs will naturally depend on the number of participating boroughs, amount of assets under management and the mix of investments that are selected for the ACS. It is expected that additional work to decide

on new investment managers and to agree costs will begin in the 4th quarter 2014 in order that boroughs can make investment decisions in 1st quarter 2015.

23. There will be professional fees and other costs associated with making the ACS fully operational (described as Establishment Costs in Fig 2 above). £625,000 of these costs has already been funded by boroughs and £344,000 committed to date. It is currently proposed that any additional costs of establishment, over and above the £625,000, would be borne by boroughs that choose to participate further in Autumn.

24. It should be noted that there is no obligation for any boroughs that choose to agree the recommendations set out in this paper to commit to any additional funding of costs. To the extent a borough takes a subsequent decision to invest in the ACS, it is proposed the borough would at that point invest further capital. (see paragraph 15).

Next Steps

25. Broadly, if the recommendations of this paper are agreed, and a number of boroughs wish to participate in the joint arrangements, the following steps will be undertaken:

    a) A new joint committee, (the 'Pensions CIV Joint Committee') will be established under the relevant legislation and existing London Councils Governing arrangements. To the extent all 33 boroughs wish to participate, London Councils Leaders' Committee would fulfil this role instead and the London Councils' Governing Agreement varied accordingly.

    b) The ACS Operator will be established, with participating boroughs having £1 of share capital in the company, and interim directors appointed.

    c) Further work will be undertaken regarding the final design and operation of the ACS Operator and ACS. The documents required by the FCA for the ACS and the ACS Operator to become authorised will be prepared.

26. A proposal will be prepared for Leaders' Committee to consider in the Autumn which will provide a clear timetable and costs for obtaining regulatory approval for the ACS Operator and the ACS, request a commitment for the initial capital of c. £100,000 from those authorities wishing to participate such that the ACS Operator can be authorised and request funding for establishing the initial staffing of the ACS Operator, and to meet any further establishment costs (per paragraphs 23 and 24 above).

Recommendations

27. Leaders' Committee is asked to:

    1. Consider the report and the underlying business case supporting the establishment of a collective investment vehicle, in the form of an authorised contractual scheme (the "ACS"), for local authority pensions in London ("the Arrangements"); AND

    2. Endorse and recommend to each local authority which decides to participate that, they resolve that:

       (a) a private company limited by shares be incorporated to be the Authorised Contractual Scheme Operator (the "ACS Operator"), structured and governed as outlined in this report, and that the local authority agrees –

(i) to become a shareholder in the ACS Operator, and

(ii) to contribute £1 to the ACS Operator as initial capital, and

(iii) to appoint an elected Councillor who will have power to act for the local authority in exercising its rights as a shareholder of the ACS Operator, and

(iv) that Mayor Pipe, Councillors O'Neill and Dombey, Mr Chris Bilsland (Chamberlain, City of London), Mr Chris Buss (Finance Director, LB Wandsworth), Mr Ian Williams (Finance Director, LB Hackney), and Mr John O'Brien (Chief Executive, London Councils) be appointed as the interim Directors of the ACS Operator, subject to the consent of their relevant authorities to the appointments. These directors may be replaced once FCA authorisation is formally applied for; and

(b) a representative body, in the form of a new sectoral joint committee (the "Pensions CIV Joint Committee"), is established (pursuant to the existing London Councils Governing Agreement, dated 13 December 2001 (as amended)) to act as a representative body for those local authorities that resolve, in accordance with 2(a) above, to participate in the Arrangement (or in the alternative, should all 33 London authorities resolve to participate, that Leaders' Committee exercise these functions and the Governing Agreement be varied accordingly); and

(c) All London local authorities respond in writing to the London Councils Chief Executive, by 14 April 2014, or before the day of the local government elections (22 May 2014), to advise of their decisions regarding the matters set out at paragraphs 2(a) and 2(b) above.

Legal Implications

28. The main legal implications are contained in this report and the attached Annex. The detail of the structure and governance of the ACS and its Operator will be firmed up as the preparatory work progresses. The establishment of a joint committee will be in accordance with arrangements under the Local Government Act 1972 and the Local Government Act 2000 to arrange for the joint discharge of decision making by the participating local authorities to support the arrangements for the collective investment vehicle. The Joint Committee will initially be established under the London Councils Governing Agreement, and the Terms of Reference of the new joint committee will provide for shared administrative functions, a forum to discuss key issues and power to appoint key directors of the ACS Operator; and it could be used more broadly if boroughs felt that to be appropriate. Should all 33 London local authorities resolve to participate, Leaders' Committee would discharge the relevant local authority functions and the Governing Agreement formally varied accordingly.

29. The Councils have power to enter into these arrangements as part of their function as an administering pensions authority taking account of its duty to invest in the interests of the pension fund and obligations in the Local Government (Pension Scheme) Management and Investment of Funds Regulations 2009. Additionally Councils have

power to invest further to Section 12 of the Local Government Act 2003 and must act in accordance with principles of best value and their general fiduciary duty.

Financial Implications

30. The Director of Corporate Resources reports that the estimate of possible costs and benefits arising from the establishment of a collective investment vehicle are detailed in full within the Annex of this report and summarised in the table at paragraph 20.

31. These figures are initial estimates and will be firmed up as preparatory work progresses, particularly in relation to the establishment and on-going costs. As detailed in paragraph 23, 25 boroughs have each been invoiced for a sum of £25,000 as a contribution towards establishment costs, amounting to £625,000 in total, with £344,000 of that sum committed to date.

32. There are some governance related issues that require further clarification, particularly surrounding the accounting requirements of the newly proposed Pensions CIV Joint Committee and how this will relate to the existing London Councils financial structures and work will continue to clarify this position.

Equalities Implications

33. There are no equalities implications for London Councils.

Attachments

Annex A: Business Case

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

14 May 2013, Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5252

19 September 2013, Executive report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5353

26 November 2013, Executive report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5490

10 December 2013, Leaders' Committee report
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5495

Business Case

1. At its December 2013 meeting, Leaders' Committee agreed the recommendations of the PWG that a business case and formal proposal should be prepared to proceed with implementation of a Collective Investment Vehicle, in the form of an Authorised Contractual Scheme (ACS). This Annex sets out the proposed business case.

2. This paper sets out further details of the proposed structure of the ACS and potential governance arrangements, including the establishment and capital requirements of the ACS Operator. It then recaps the financial benefits which may arise from operating an ACS, and sets out further details of the expected costs.

Proposed structure

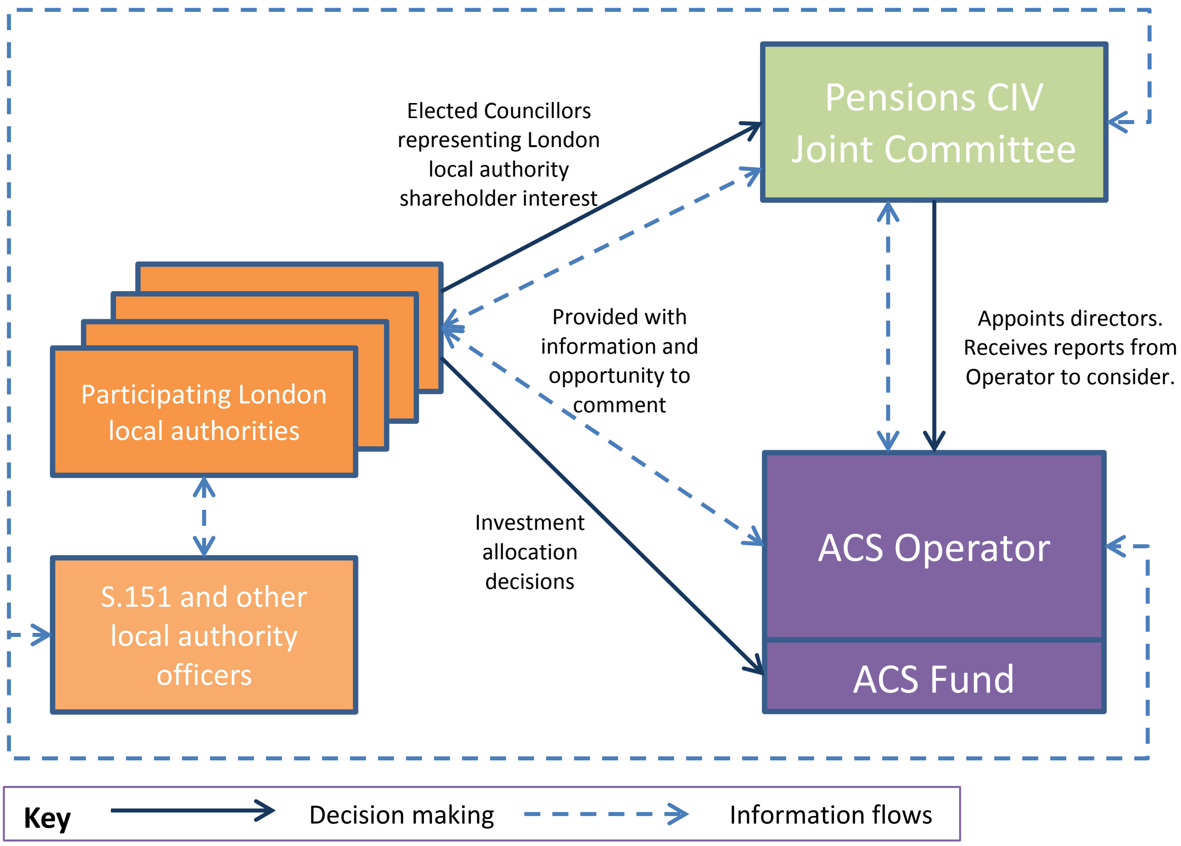
3. It was previously agreed that the most appropriate structure for the CIV is an ACS fund and nothing has emerged to suggest that that recommendation should change. The ACS will require an FCA regulated ACS Operator to be established. The board of directors and employees of this company will have overall responsibility for the operation of the ACS.

4. In broad terms, the proposed structure is that the participating boroughs will own all the share capital of the ACS Operator. Initially this will require minimal share capital (£1 per borough from those who wish to participate) but this capital requirement will increase once the operator is authorised and investments are made in the ACS. The capital requirements are considered in more detail at paragraph 32 onwards.

5. A new 'Pensions CIV Joint Committee' will be established to assist in the appointment of key directors of the ACS Operator, such as the Chairman and Chief Executive Officer. The Pensions CIV Joint Committee will comprise elected Councillors nominated by participating boroughs. Information will be provided regularly by the ACS Operator to investors in the ACS and borough Pension Committees and officers, and the Pensions CIV Joint Committee.

6. The governance arrangements and lines of communication between various interested parties are illustrated in the diagram below.

Fig 1 – CIV governance and communication lines



7. The following sections set out the above arrangements in more detail, setting out the governance arrangements, potential staff requirements, and the proposed process for investment manager selection and asset allocation.

Governance structure of the ACS Operator

8. The process for governance and decision making has been considered in some detail, and there are a range of options for how the governance arrangements could be structured. The precise arrangements would always be open to Council scrutiny and amendment, and subject to FCA requirements, but what is laid out below is seen as appropriate initial proposals to take the project forward at this point. Extensive legal advice has been taken and has been used to formulate the proposals that lead to the framework described below.

9. It is proposed that a new joint committee (the 'Pensions CIV Joint Committee') will be established under both section 102 of the Local Government Act 1972, Section 9EB of the Local Government Act 2000, and clause 3.1 of the existing London Councils' Governing Agreement, to act as a representative body for those local authorities that have chosen to participate, and would be made up of the Leaders (or another nominated elected Councillor) of those councils participating in the ACS. Should all the boroughs participate, this role would be performed by London Councils' Leaders' Committee (and the Governing Agreement would need to be formally varied). In relation to the make-up of this joint committee, it is proposed that boroughs that agree to become a shareholder in the ACS Operator would appoint a representative who will sit

on this committee. Whilst typically the borough Leader might be appointed as the representative on the joint committee, in the event that meetings are required to deal with specialist matters e.g. discussions on investment matters, it may be that a person with appropriate expertise would act as a deputy to attend such meetings, e.g. for investor matters, the Chair of the relevant Borough Pension Committee could be appointed. A deputy would need to be appointed at the same time as the main representative. Provision is made for these arrangements under the existing London Councils Governing Agreement dated 13 December 2001 (in particular refer to clauses 3.1 and 4.5 of the Agreement and Standing Orders).

10. One of the main purposes of the Pensions CIV Joint Committee will be to act as a forum to recommend/approve the appointment of key directors to the board of the ACS Operator. The ability to appoint directors of the ACS Operator ultimately rests with the shareholders (who in practice, the Elected Councillors sitting on the joint committee represent) and analysis is currently on-going to determine the most appropriate methodology for the wishes of the shareholders to be executed in a manner which is acceptable given various constraints that exist within local government, Companies Act 2006 requirements, and FCA regulations.

11. The exact mandate of the joint committee will require further consideration. The frequency of meetings of the joint committee also needs to be decided.

12. Should boroughs be minded to proceed with establishing the ACS Operator, at this stage the company can be established with interim directors, with formal appointments for the ongoing directors made later in the year, prior to FCA approval. It is proposed that, subject to no impediment for the individuals, the members of the Pensions Working Group would sensibly be asked to take the roles of interim directors, augmented by the Chief Executive of London Councils. For clarity that would be Mayor Pipe, Councillors O'Neill and Dombey, Mr Chris Bilsland (Chamberlain, City of London), Mr Chris Buss (Finance Director, LB Wandsworth), Mr Ian Williams (Finance Director, LB Hackney), and Mr John O'Brien (Chief Executive, London Councils). Their appointment would be subject to the consent of their relevant authorities.

13. It is proposed that up to three elected Councillors from the Pensions CIV Joint Committee could be directors of the ACS Operator. The directors have to be approved by the FCA and will have fiduciary duties and responsibilities. The decision as to who could be in these roles is to be decided. It is not a requirement for Elected Councillors sitting on the joint committee to have any director roles, and this will be one of the early matters on which the initial participating boroughs who join the joint committee and participate in the ACS will be asked to decide.

14. The ACS Operator will provide regular information to the participating Borough Pensions Committees about the ACS. The Borough Pensions Committees would be given the right to receive presentations by the investment managers on performance.

15. As illustrated in Figure 1, it is recognised that s.151 officers will provide advice to both their representative joint committee elected Councillor, and their Borough Pension Committee. In addition, it is anticipated that Treasurers may require occasional opportunities to receive information directly from the ACS Operator and to raise any

issues or questions. The Society of London Treasurers is likely to have a role in facilitating discussions with the ACS Operator at an officer level where those matters under discussion collectively affect Treasurers' authorities.

Staff resources

16. In terms of staffing requirements, there are a number of roles required within the ACS Operator, and the precise detail of the final establishment of the ACS Operator will need to be confirmed later. However, in order to understand costs, the following has been assumed. Firstly, there would be 2-3 FTE admin staff, who are likely to be graded at bands B and C on London Councils' salary scales. These staff would assist in the running of the ACS Operator, for example drafting and reviewing reports, and providing support to the meetings of the board of directors, relevant committees of the board, and support teams.

17. At the outset, there will also be a lot of activity in respect of investment management selection. This may require 5 to 6 individuals, with a strong level of understanding of the process for selection of managers. It is thought that this group could comprise of a number of existing borough pensions staff, potentially seconded into the ACS Operator for a period of time. Potentially an external hire may also be required. This group would undertake the activities which would ultimately lead to a recommendation being made to the ACS board as to investment mandates of the ACS and the managers to appoint, in a similar fashion to the existing arrangements within boroughs where pension officers will report to their Pensions Committee. Further details are set out at paragraph 22 onwards.

18. To oversee the activities set out above, and oversee and manage suppliers, it is expected that a chief operating officer would be required. In the first instance, this is likely to be a full time role, however once the ACS Operator and ACS are fully established, the time required may decrease. The need for this role, its responsibilities, and options for filling it, could be considered by the ACS Operator interim directors (see paragraph 12).

19. In addition, a chief executive officer and finance director would be required. These are expected to be part time roles, and could potentially be undertaken within the existing roles of London Councils. These decisions do not need to be taken immediately and, again, could be addressed by the interim directors as one of their early decisions. A compliance director, risk officer, anti-money laundering officer, and chief investment officer will also be required, and how to source these individuals will be considered as an early part of the process. It should be noted that, in addition to the liability of the corporate entity, individuals in these roles need approval from the FCA and have personal liability.

20. To the extent that resource is not available, either from within London Councils or seconded from boroughs, additional third party or professional costs may be incurred. It is anticipated that these costs will be analysed in due course once the key roles have been more fully defined and the availability of suitable internal resources have been considered.

21. The fact that the boroughs will have a significant role both at the level of the ACS Operator and as investors in the ACS means that the FCA will require a robust conflicts of interest policy to be in place.

Investment manager selection and asset allocation

22. There are two key areas of responsibility which will allow boroughs to select the investments they wish to make. Following consultation with boroughs, the ACS Operator will offer a number of mandates to investors and will select a number of managers for this. The final decision over the selection of managers rests with the board of directors of the ACS Operator. The decision regarding asset allocation and whether to invest in the mandates being offered will be at the full discretion of each borough.

23. It is proposed that investment manager selection would be undertaken by an investment advisory team of the ACS Operator as described in paragraph 17 above which would report into the board of directors. There are a range of options for how this is set up, as the team can comprise elected Councillors, officers, and external hires if required. The preferred composition of this group would be decided in due course, but it is expected to be a mix of elected Councillors and officers, probably 6 to 8 in number. The majority of the roles on this group are expected to be part time although as more assets are added to the ACS and additional mandates and alternative investments are added, some of these roles may become full-time.

24. Once the ACS itself is established, it would be at the discretion of the boroughs whether they choose to invest in any or all of the ACS sub-funds. In order to allow individual borough to decide asset allocations between managers, the assumption is that the fund structure will be an umbrella fund, with each sub-fund having a specific investment mandate and investment manager. If a borough decides to invest in a particular mandate, they would simply acquire units in the relevant sub-fund. Please see Appendix A for a visual representation of this structure.

Legal and regulatory considerations

25. This section sets out some of the legal and regulatory considerations in connection with the set-up of the ACS Operator and the ACS, and sets out a timeline for achieving this.

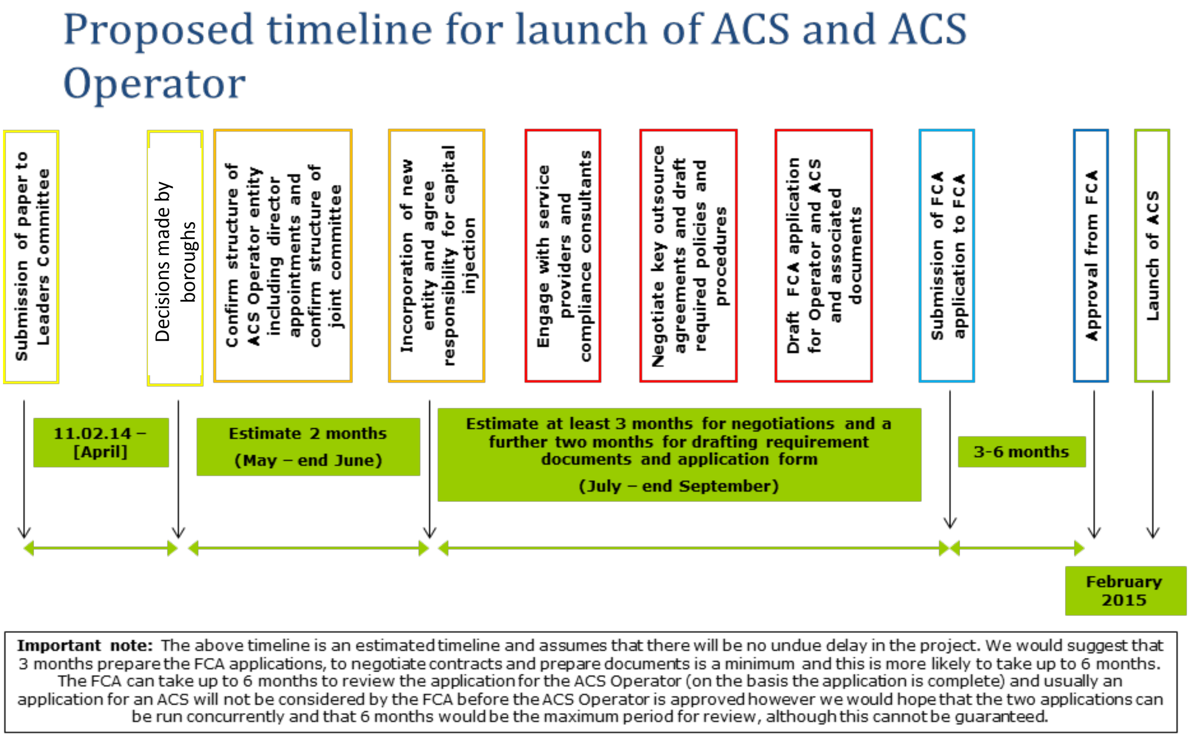
26. The ACS will require a Financial Conduct Authority (FCA) regulated ACS Operator to be established. Typically this is in the form of a limited liability company, which is proposed here. The ACS Operator and the ACS are heavily regulated. There is a separate authorisation process for each of them, involving different divisions of the FCA. The process for the authorisation of the ACS Operator requires detailed information to be supplied in particular around the qualifications of the board and key employees, their ability to carry out the key operational functions or supervise delegates, financial requirements etc. The form requires detailed information. The authorisation process can take between 6 and 12 months. As this application is for local authorities it is hoped that the application for the ACS operator and the ACS would be run concurrently by the FCA and we would hope the authorisation process would take nearer to six months than twelve, however this cannot be guaranteed.

27. The board of directors and employees of the ACS Operator will be responsible for the overall operation of the ACS. In order to meet these obligations it will need to appoint a number of external service providers, including the administrator, the registrar and transfer agent and investment managers. These appointments will need to be reasonably advanced to submit detail and draft documents to the FCA at the time of the application for authorisation.

28. In addition to the corporate entity being authorised individuals performing certain functions as described in this paper also require personal approval by the FCA.

29. We have set out below a proposed timetable for the launch of the ACS Operator and the ACS. This is subject to change and dependent on a number of factors, such as consideration by Leaders' Committee, relevant decisions being taken by the boroughs wishing to participate in the arrangements, selection of key personnel and negotiation of key contracts.

Fig 2. Proposed timetable for launch



30. The proposed timeline emphasises when certain decisions will need to be made. For example the fund mandates and strategies, and you will also note that certain service providers will need to be identified shortly following the incorporation of the ACS Operator entity, so that key commercial terms and service levels can be agreed. As discussed further below, the FCA application forms require in depth detail and draft documents which will take time to agree and complete and as such it is critical to consider these factors at the outset.

31. During the ACS establishment process, some regulatory clarifications will be required although it is not currently expected that there will be any material difficulties. In

particular, it will be important to confirm that a borough will be able to invest substantially all of its pension assets in a single ACS vehicle. Restrictions currently apply to certain collective investment vehicles. Whilst specific reference to ACSs is not made it will be important to ensure that the legislation is either amended or made clear that ACSs (and possibly other collective investment vehicles) which are operated by local authorities are carved out from these restrictions.

Capital requirements of the ACS Operator

32. Initially the ACS Operator will only require minimal share capital and, as such, it is recommended that each borough that wishes to proceed will acquire £1 of share capital in the company.

33. Immediately before the ACS Operator receives regulatory approval (expected to be 4th quarter 2014, see timetable comments at paragraph 30), it will require capital of c. £100,000. The calculation of regulatory capital is complex, and depends on a variety of factors, including the expected fixed overheads of the ACS Operator.

34. It is proposed that the c. £100,000 of ACS capital would be contributed by those boroughs which choose to move forward with the ACS in Autumn – so for example if 10 boroughs decided to proceed with the ACS in Autumn, this would require a capital contribution of £10,000 per borough. It should be noted that this contribution is an investment rather than an expense as this capital would be invested in liquid assets such as gilts rather than being used to pay expenses.

35. Once the ACS starts receiving investments, the ACS Operator will require additional capital, which may be c.2 to 3 basis points of assets invested in the ACS (for £5bn of assets invested in the ACS, the ACS Operator would require capital of £1m to £1.5m). This capital is broadly required at the point in time when the assets under management are due to increase. The total required regulatory capital of an ACS Operator will not exceed 10m euros.

36. Once boroughs choose to invest pension assets in the ACS, it is proposed that they would contribute capital to the ACS Operator in proportion to the assets invested. It is not expected that this should materially impact any return to the boroughs as the funds invested could be from existing pension assets which are currently invested in gilts or similar investments. As such the borough could retain exactly the same profile for its pension investments except that a very small proportion of their assets invested via gilts would be held indirectly through the ACS Operator rather than directly as at present. The precise capital requirements, and the mechanism for the contribution of this capital, will be considered in more detail in the next phase of the project.

37. It should be noted that boroughs who contribute £1 of share capital now will be under no obligation to make any further capital payments to the ACS operator. To the extent a borough takes a subsequent decision to invest in the ACS, it is proposed the borough would at that point invest further capital.

Financial Case

38. Having considered the potential structure and process for establishment, the following sections consider the financial case in more detail. There are a number of areas to

consider. Firstly the potential financial benefits of the ACS, and then the potential costs. These are considered in more detail below. It is clear that, based on the expected savings previously identified, forecast costs should be comfortably covered by savings in reduced management fees.

Financial benefits

39. The 33 London boroughs currently have over £20bn of pension assets under management. Previous work undertaken by PwC estimated savings in the region of £120m per annum from the creation of a CIV, provided there was close to full participation by authorities. Costs of running the ACS were estimated to be between 1 and 5 basis points (0.01% to 0.05%) of assets under management with the estimated costs, for full participation from all 33 London local authorities, estimated to be £4.8m per annum. At lower levels of participation, both the financial benefits and the costs would reduce. More work has now been undertaken on potential costs and benefits, based on high level assumptions, and these are summarised in the table below. It is clear that, based on the expected savings previously identified, forecast costs should be comfortably covered by savings in reduced management fees.

40. The primary cost savings previously identified were in respect of lower investment management fees, and improved performance. Further work since then indicates that there may be further savings in other areas. For example, when investing in a third party fund, it is likely that income from activities such as stock lending and foreign exchange will be earned, however may not be passed on to the boroughs and their pension investments to the same level as could be possible in the ACS. It has been estimated that the income from these activities could be in the region of 10 to 20 basis points. There is no current information available about the level of return that is currently allocated to boroughs in relation to their existing pension investments.

41. Additional analysis of costs has been undertaken since the PwC report. The broad conclusion of this analysis is that, depending on the level of participation, the marginal costs for investing in the ACS are likely to be in the middle of the original 1 to 5 basis point estimate and that there are potential additional savings that could be made.

42. A reasonable minimum target size of assets management for the ACS is considered to be in the range of £5bn of assets. This is based on work undertaken by the PWG, which shows that there are a number of boroughs who currently have very similar investment mandates with exactly the same investment managers. This research suggests that if 6 of the largest similar mandates with identical investment managers across a range of passive and active equity and bond mandates were selected in the ACS, scale of around £3bn could be achieved without any individual borough pension funds materially changing their currently selected mandates or manager. On the assumption that a number of other London boroughs would also be minded to invest in the ACS if it offered these mandates and given the initial interest expressed by boroughs in participating, a minimum target size of £5bn appears a reasonable assumption.

43. Indicative costs and potential savings are set out in the table below, for assets under management of £24bn, £10bn, and the minimum target size of £5bn explained at paragraph 42.

Fig 3. Summary of potential savings and costs

	Assets under management £24bn £ 000's	Assets under management £10bn £000's	Assets under management £5bn £ 000's
Expected savings per annum[1]			
Investment management fees - 15 bps	36,000	15,000	7,500
Improved performance - 35 bps	84,000	35,000	17,500
Total expected savings	**120,000**	**50,000**	**25,000**
On-going Costs per annum[2]			
Custody costs			
Custody costs (at 3.5bp, 4bp and 5bp)	(8,400)	(4,000)	(2,500)
Incurred in existing third party funds ***(3)***	3,600	1,500	750
Net Custody Cost	(4,800)	(2,500)	(1,750)
Other Costs			
Salaries –e.g. COO/Admin	(400)	(400)	(400)
- Audit/advice	(200)	(150)	(100)
- Offices/expenses	(200)	(200)	(200)
- Misc. Advisory	(500)	(400)	(300)
Total On-going Costs	**(6,100)**	**(3,650)**	**(2,750)**
Establishment costs [2][3]			
- Transition advisory including custody selection	(700)	(500)	(400)
- Other misc. fund advisory	(500)	(500)	(500)
- Legal, regulatory, and financial advice (funded already)	(600)	(600)	(600)
Total Establishment Costs	**(1,700)**	**(1,500)**	**(1,400)**

Notes

(1) These savings are as previously reported. They have been allocated on a straight-line basis for assets under management less than £24bn. This is an assumption made for simplicity and any real savings may well be less and will depend on types of mandate, asset mix, etc. There are also other potential areas where financial benefits may arise, such as increased income from activities such as stock lending, which have not been quantified within the above.

(2) All costs (other than custody costs) are estimated on very high level assumptions and may not reflect final costs.

(3) For "other costs" and "Establishment costs", some of these expenses would be incurred in existing investments or on changes of manager/investment. No attempt has been made to estimate these existing costs to date.

Custody costs

44. The main cost associated with running the ACS is from the custody of the assets. Custody costs are calculated as a basis point fee on the amount of assets, with the basis point fee reducing on a sliding scale as the amount of assets under custody increases.

45. In order to consider potential costs, assumptions regarding the potential value of the fund and number of sub-funds and investors have been made. These consider 3 possible scenarios based on the most commonly used asset classes, which are set out below. The assumptions used are not recommendations and are purely for illustration purposes for the business model:

    - sub-funds representing the most frequently used asset classes with minimal uptake by London local authorities investing 50% of total value in these asset classes into the fund,
    - broader range of sub-fund asset classes with a third of London local authorities investing 50% of total value in these asset classes into the fund,
    - all London local authorities investing 75% of total value in these asset classes into the fund.

46. Based on the above, the indicative cost of running the fund may be as follows:

    - 5 investors in 4 sub-funds (made up of mix of passive and active, global equity and UK equity) total £1bn, up to 10bps/minimum charge circa £500k per annum,
    - 11 investors in 10 sub-funds (made up of mix of passive and active, global equity, UK equity, global bonds, & alternatives) total £6bn, up to 5 basis points,
    - 33 investors in 15 sub-funds (made up of mix of passive and active, global equity, UK equity, global bonds, UK bonds & alternatives) total £14bn, up to 3.5 basis points.

47. These costs include Fund Administration (Transfer Agency and Fund Accounting), Depositary and Custody. These costs would reduce where additional services e.g. a proportion of cash, foreign exchange and Securities Lending services are also conducted by the appointed Custodian (which is standard with London boroughs existing custody arrangements). Other factors that feed into the cost consideration include the frequency of investor dealing and frequency of valuation points. It should also be noted that Fund Accounting fees typically operate on a sliding scale with minimum fees per sub-fund, therefore the larger each sub-fund in terms of value the more cost effective.

48. In terms of a cost-benefit analysis, it is important to note that borough pension funds already pay custody fees either directly for existing segregated mandates or indirectly in third party fund investments. Accordingly, the cost-benefit analysis needs to look at the amount by which the custody costs that would be incurred from investing in an ACS exceed current custody costs borne by the boroughs on their existing investments.

49. In relation to existing segregated mandates, it is likely that savings would be achieved through moving such mandates to an ACS as this would reduce custody costs. This is

because most existing segregated mandates are relatively small and accordingly consolidating these mandates in the ACS should increase the amount invested in each mandate which in turn would result in a lower basis point custody charge.

50. In relation to existing third party funds, the cost-benefit analysis is more complex because it is difficult to determine the custody fees that are payable by the investment managers that have established these funds as such numbers are not always publicly available. An estimate of these costs would be in the 1 to 2 basis point range.

51. Based on this analysis, it appears that for higher levels of participation the costs will be lower than previously anticipated. For very low levels of participation (e.g. £1bn) the costs could be higher than the 5 basis point charge previously anticipated. Even at a £1bn level of participation, there may well be financial benefits associated with establishing an ACS but this level of participation is below the minimum level that might reasonably be expected.

52. At a level of assets of £5bn the additional custody costs would be expected to be in the range of 3 to 4 basis points (or £1.5 to £2m per annum), being an ACS custody cost of c.5 basis points less the 1 to 2 basis point charge which would have been incurred on existing investments.

Other costs and benefits

53. Other on-going costs of the ACS are likely to include staff costs, FCA fees, consultancy fees and administration costs including audit and taxation. These fees would be charged directly to the fund, as they would be now. Consultancy fees might include professional advice on investment manager selection. As this would be performed centrally at the ACS level rather than multiple times at individual borough level, it is likely that savings would be achieved in this regard. Admin costs would not be expected to be significant compared to the benefits identified.

54. In relation to staff costs, this is considered in more detail below but on the basis that it is expected that a majority of functions may not be full time and might be performed by existing local authority personnel, additional staff costs are not expected to be significant. For the purposes of the cost benefit analysis undertaken, an estimate of £400,000 per annum has been made. Practically, the roles which might be required are set out below.

Establishment costs

55. There will be a number of establishment costs incurred in setting up the fund. These will be one-off costs in the first year.

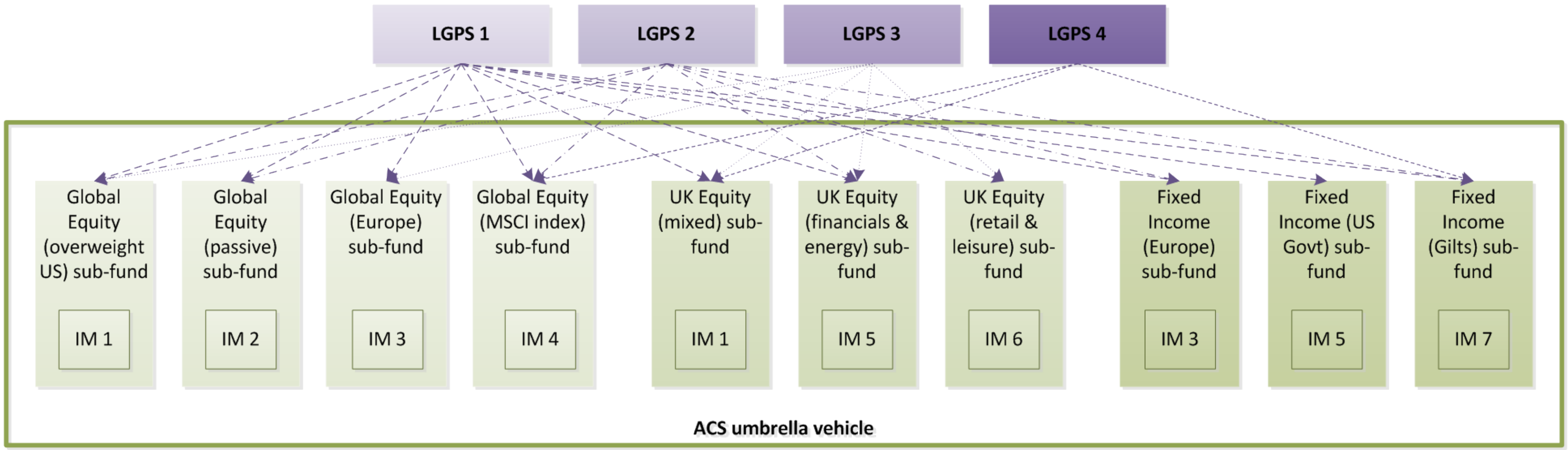
56. £625,000 has already been contributed to these costs by the boroughs, in order to engage professional advisors to perform the necessary financial and regulatory work. It is currently expected that this work will be performed within this existing budget.

57. As the project progresses, additional professional fees are likely to be incurred, for example to assist in training relevant individuals on their regulatory roles and to assist in the development of procedure manuals. It will become clearer in due course where costs may arise in this regard.

58. The transition of assets into the fund will also need to be considered, as assets are moved from existing managers to new managers appointed to the ACS. To a large extent, boroughs already incur similar costs as they transition assets to different managers in the ordinary course of their pension activities. As such these costs may well simply offset existing costs incurred by boroughs although clearly this depends on the level of fees currently charged and the number of transitions. Until further decisions are taken on the mandates that will be launched in the ACS, it is difficult to estimate accurately what these costs might be. An estimate of advisory fees required in connection with this transition management is included within the table, and is based on the experience of advisors on similar projects. It should be noted that the boroughs currently have regular manager transitions, and as such the costs of transition from setting up the ACS should result in lower annual transition costs going forwards.

59. From a tax perspective, the transfer of UK securities into an ACS should not be subject to UK stamp duty reserve tax (SDRT), and a tax clearance can be obtained in advance to give comfort. It is envisaged that the costs of transition would be borne by the pension funds who are moving their assets into the fund, and the cost would depend on the assets being moved. Due diligence will be needed for individual pension funds should they choose to invest, to consider the most appropriate way to transition into the fund.

Appendix A - Indicative ACS umbrella structure



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Deloitte.

London LGPS CIV: Briefing for Local Authority Officers

The report to Leaders' Committee from the Pensions Working Group

5 February 2014

Recommendations

Leaders' Committee is asked to:

1. Consider the report and the underlying business case supporting the establishment of a collective investment vehicle, in the form of an authorised contractual scheme (the "ACS"), for local authority pensions in London ("the Arrangements"); AND

2. Endorse and recommend to each local authority which decides to participate that, they resolve that:

a) a private company limited by shares be incorporated to be the Authorised Contractual Scheme Operator (the "ACS Operator"), structured and governed as outlined in this report, and that the local authority agrees –
   i. to become a shareholder in the ACS Operator, and
   ii. to contribute £1 to the ACS Operator as initial capital, and
   iii. to appoint an elected Councillor who will have power to act for the local authority in exercising its rights as a shareholder of the ACS Operator, and
   iv. that Mayor Pipe, Councillors O'Neill and Dombey, Mr Chris Bilsland (Chamberlain, City of London), Mr Chris Buss (Finance Director, LB Wandsworth), Mr Ian Williams (Finance Director, LB Hackney), and Mr John O'Brien (Chief Executive, London Councils) be appointed as the interim Directors of the ACS Operator, subject to the consent of their relevant authorities to the appointments . These directors may be replaced once FCA authorisation is formally applied for; and

b) a representative body, in the form of a new sectoral joint committee (the "Pensions CIV Joint Committee"), is established (pursuant to the existing London Councils Governing Agreement, dated 13 December 2001 (as amended)) to act as a representative body for those local authorities that resolve, in accordance with 2(a) above, to participate in the Arrangement (or in the alternative, should all 33 London authorities resolve to participate, that Leaders' Committee exercise these functions and the Governing Agreement be varied accordingly); and

c) All London local authorities respond in writing to the London Councils Chief Executive, by 14 April 2014, or before the day of the local government elections (22 May 2014), to advise of their decisions regarding the matters set out at paragraphs 2(a) and 2(b) above.

Overarching Principles

In considering the proposed structure of the ACS and its Operator, the PWG have sought to adhere to the following overarching principles, in order that the arrangement can best meet the requirements of the boroughs:

- Investment in the ACS should be voluntary. A borough should be able to decide they do not wish to participate, or to the extent they initially decided to participate, to choose to withdraw their investment.
- If a borough chose to invest, it will be able to choose which asset classes to invest into, and how much they might invest into each asset class.
- The boroughs should have sufficient control over the ACS Operator, in order to be assured that it will be acting in their best interests.
- The ACS Operator would provide regular information to participating boroughs regarding the performance of managers, investment options, and other areas, so that information continues to be available to the same extent it is currently in order for boroughs to make investment decisions.
- Authorities seeking to invest in the ACS will also take a shareholding interest in the Operator (and have membership of the Pensions Joint committee).
- The ACS will not increase the overall investment risk faced by boroughs.

The governance arrangements and lines of communication between various interested parties are illustrated in the diagram below.

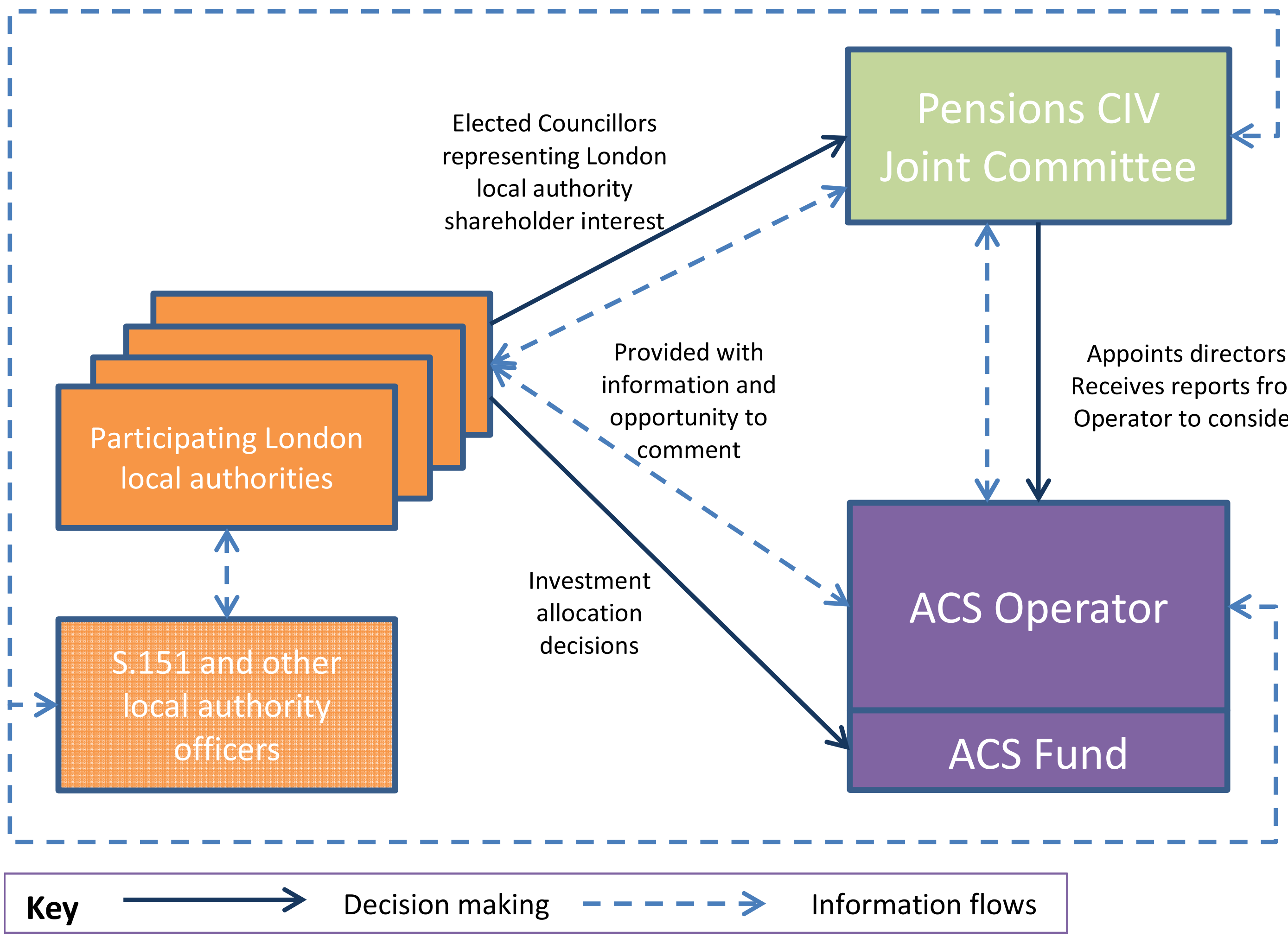


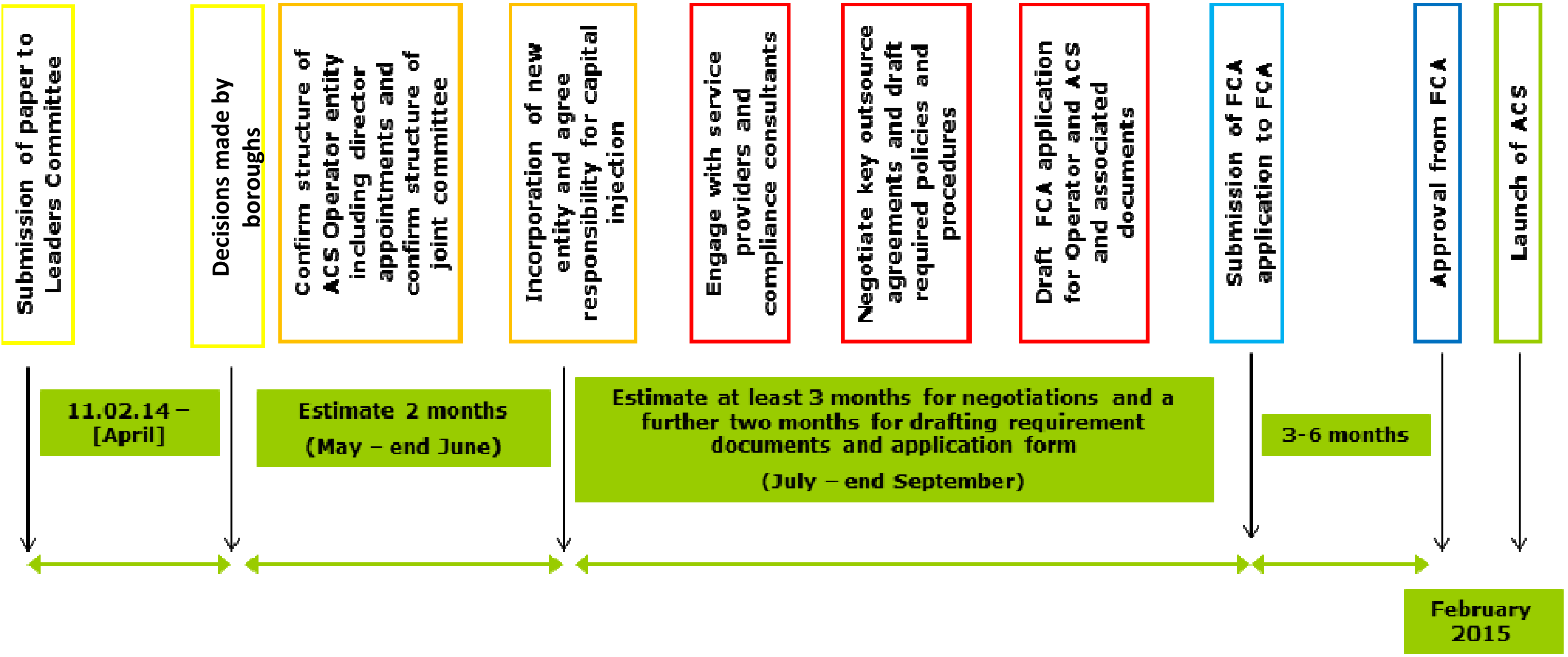
Fig 1 – CIV governance and communication lines

Page 48

Proposed timetable for launch

The proposed timeline emphasises when certain decisions will need to be made. For example the fund mandates and strategies, and you will also note that certain service providers will need to be identified shortly following the incorporation of the ACS Operator entity, so that key commercial terms and service levels can be agreed.

Proposed timeline for launch of ACS and ACS Operator



Important note: The above timeline is an estimated timeline and assumes that there will be no undue delay in the project. We would suggest that 3 months prepare the FCA applications, to negotiate contracts and prepare documents is a minimum and this is more likely to take up to 6 months. The FCA can take up to 6 months to review the application for the ACS Operator (on the basis the application is complete) and usually an application for an ACS will not be considered by the FCA before the ACS Operator is approved however we would hope that the two applications can be run concurrently and that 6 months would be the maximum period for review, although this cannot be guaranteed.

Page 49

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