Non-Executive Report of the: **PENSIONS BOARD** **20 November 2015**	TOWER HAMLETS
Report of: Zena Cooke, Corporate Director of Resources	**Classification:** Unrestricted
LGPS – current Developments and Update (Pooling, London CIV, MiFID II, Fossil Fuel and Scheme Advisory Board Work)	

Originating Officer(s)	Bola Tobun, Investment and Treasury Manager
Wards affected	All

Summary

This report covers a range of relevant pension's related issues for the Board to be aware including changes to pensions saving and future consultation on pooling of investments in the LGPS.

The attached report covers:

1. Pooling of investments in the LGPS
2. MiFID II Impact on LGPS and Local Authorities
3. Fossil Fuel Divestment Campaign
4. Scheme Advisory Board work on separation of Pension Funds

Recommendations:

Members of the Pensions Board are asked to:

- Note the contents of the report.

1. REASONS FOR THE DECISIONS

1.1 No decision required

2. ALTERNATIVE OPTIONS

2.1 No alternative as this is for information and update.

3. DETAILS OF REPORT

3.1 Pooling of investments in the LGPS

3.1.1 The Chancellor announced that a consultation on the pooling of investments for the LGPS would take place in his July budget update:
"*Local Government Pension Scheme pooled investments – The government will work with Local Government Pension Scheme administering authorities to ensure that they pool investments to significantly reduce costs, while maintaining overall investment performance. The government will invite local authorities to come forward with their own proposals to meet common criteria for delivering savings. A consultation to be published later this year will set out those detailed criteria as well as backstop legislation which will ensure that those administering authorities that do not come forward with sufficiently ambitious proposals are required to pool investments*."

3.1.2 The Chancellor followed this up with a speech at the Conservative Party Conference "We are going to find new ways to fund British infrastructure that drives our productivity…. At the moment we have 89 local government pension funds with 89 sets of fees and costs. It's expensive, and they invest little or nothing in our infrastructure. So I can tell you today we are going to work with councils to create half a dozen British wealth funds spread across the country."

- He said this plan would save "hundreds of millions in cost, and crucially they will invest billions in the infrastructure of their regions."
- Further information published on the U.K. government website said that small local pension funds "lack the expertise to invest in infrastructure." Of the £180 billion of assets in these plans, only 0.5% is invested in infrastructure projects. Countries with larger pooled public pension funds invest up to 8% in infrastructure, and 17% in housing and infrastructure, according to the website.

3.1.3 Whilst officials from DCLG have stressed that there is no specific cost saving target, the figure of £660m continues to be referenced by ministers. Also officials are keen to point out that government does understand the fiduciary responsibilities of the LGPS in ensuring that investments are made for the right investment return and risk reasons rather than just to fund UK infrastructure and that there is not expected to be any compulsory for the funds to invest in infrastructure.

3.1.4 The consultation on pooling is expected to be issued in November, but the government has made it clear that it is looking at the LGPS coming forward with proposals for pooling of investments with pool sizes of between £25-30bn and for 5-6 pools.

3.1.5 The consultation is expected to cover:

- Legislative changes circulated in draft to give the Secretary of State increased powers;
- Proposed changes in the investment regulations;
- Acceptable criteria for pooling;
- Back stop measures for recalcitrant schemes.

3.1.6 At the time of writing, nothing had been formally announced on timeframes, although the expected timeline is set out below:

Government to commission and receive independent advice	Oct 2015
Consultation (and the backstop enforcement regulation)	Early Nov 2015
Consultation response from all stakeholders (expectation is for 12-week response period)	Early Feb 2016
Draft Regulations	Published March 2016 Effective date April 2016
Creation of asset pools (phased in over three years)	April 2019
Transition of assets for those funds not meeting the requirements	Unknown

3.1.7 There are no plans to formally consult on the criteria for pooling, although the government has made it clear in discussions on the pooling objectives that the four key criteria are:

- Scale (£25-30bn pool target);
- Cost Savings;
- Governance;
- Infrastructure

3.1.8 Whilst the government has expressed a preference for regional pooling, it has emphasised that it is willing to consider alternative proposals. It has made it clear that it is looking for local government to come forward with suitable proposals for consideration. Government has publicly acknowledged the advance already made in this area made by some Funds, and indicated that it is its intention is to build on that progress. Following the budget statement, the Lancashire/LPFA, the London CIV and the LGPS National Frameworks have all stated that Government has individually reaffirmed to them that their initiatives are consistent with the objectives for fee savings through scale economies. Indeed the London CIV is referenced by government as a model for others to consider although it has indicated that it is perhaps concerned about the voluntary nature of the arrangements with London Funds retaining options around which assets to pool in the CIV. It is clear that the government sees that the Administering Authority should retain the asset allocation decision for the individual funds but that they expect the choice of investment managers to be made by the investment pool itself.

3.1.9 As might be expected, following the government announcement and follow up discussions with government departments, the majority of LGPS Funds are now considering options for pooling and collaboration with others. To a certain extent with the London CIV already in progress, most London funds have stood aside with discussions with funds outside of London, seeing the CIV as their pooled vehicle to take their funds forwards into pooling.

3.1.10 One major project being assisted by Hymans Robertson is Project 'POOL' a collaboration of metropolitan and county authorities which is looking at a range of options to come forward with proposals for government during the consultation period. This includes consideration of regional pools along with pools run along asset class lines and also an in-house investment option. Other projects include one for Wales which would amount to around £10bn of assets, but is expected to be acceptable despite its relatively small size. The South-West is also looking at options for a pool in the region along the lines of previous framework agreements.

3.1.11 Three pension funds have also reported to be in talks to launch an investment partnership comprising East Riding, Surrey and Cumbria. These are just an indication of some of the discussions underway between the 89 funds in England and Wales. Whilst it is not expected to be available for the Board meeting on the 20th November, should the consultation be issued by the time of the meeting a further update will be provided to the Board.

3.2 London CIV

3.2.1 The London CIV continues to make progress and the Financial Conduct Authority (FCA) authorised the company as an Alternative Investment Fund Manager on 15 October 2015. The Company's entry in the FCA register can be found here:

https://register.fca.org.uk/ShPo_FirmDetailsPage?id=001b000000sD6OtAAK

3.2.2 The application for Fund authorisation was submitted to the FCA on 15 October and it is hoped to have the authorisation confirmed by the middle of November. The FCA is treating the application as a priority and, while no promises will be made, they have indicated that best efforts will be made to meet the desired timetable. If the FCA authorise the Fund in line with the ideal timeline it should be possible to launch the CIV's first sub-fund before the end of the year. On the assumption that the first fund will be launched as planned the aim is to open the remaining eight sub-funds in the first quarter of 2016. Detailed fund information has been sent to all the boroughs that are invested in the same or similar mandates with the relevant Fund Managers and each borough has been asked to give feedback about their intention to transition to the CIV or not. If all boroughs do transition the CIV will have in excess of £6bn under management by the end of this financial year.

3.2.3 Regulatory Capital: with the adoption of the revised Articles and the signing of the Shareholders Agreement it has been possible to issue share subscription letters to each borough for the B shares that will generate the required regulatory capital. The London Borough of Tower Hamlets Pension Fund in accordance with the Committee's decision will pay the regulatory capital to the CIV.

3.2.4 The Investment Advisory Committee (IAC) has now been established and is working on a range of options for consideration by the Sectoral Joint Committee with papers at the recent meeting on Infrastructure.

3.2.5 Working groups have been established to come forward with proposals on ethical tracker funds, options for fixed interest, further work on infrastructure, private rented sector and social housing.

3.2.6 The London Collective Investment Vehicle (CIV) is entering its final implementation phase, the Fund has been asked to make the final investment decision to invest in sub-funds proposed for the CIV launch in November 2015.

3.2.7 Four managers have now been identified as offering potential opportunities for the launch of the CIV. These managers will provide the CIV with 9 sub-funds, covering just over £6bn of Borough assets and providing early opportunity to 20 boroughs. The sub-funds will consist of 6 'passive' equity sub-funds covering £4.2bn of assets, 2 Active Global Equity mandates covering £1.6bn and 1 Diversified Growth (or multi-asset) Fund covering just over £300m.

3.2.8 20 boroughs are currently invested in one or more of these mandates and LBTH is one of them. Those boroughs that do not have an exact match across for launch are able to invest in these sub-funds from the outset at the reduced Asset Management Company (AMC) rate that the CIV has negotiated with managers.

3.2.9 There are a number of other managers with whom discussions are still ongoing, but these are currently being viewed as 'post-launch' (phase 2, spring 2016) opportunities.

3.2.9 LBTH Pension Fund is one of the London LGPS Funds with direct links to the launch sub-funds. An indication was given to London CIV by the s151 officer having consulted with the Chair and Vice Chair of the Pensions Committee, that the Fund would transfer the current holdings with one of the two global equity managers to the CIV and to hold on transferring the UK Equity mandate to the CIV pending more desirable negotiation entry terms for this mandate.

3.3 National LGPS Frameworks

3.3.1 The Fund Officer is now working closely with a number of other authorities to develop national procurement frameworks, with the work of the group being recognised at the recent LGC Investment Awards.

3.3.2 Current frameworks under development include the re-letting of the actuarial and investment consultancy frameworks as they are nearing the end of the 4 year framework lifespan for the original frameworks. In addition the Environmental, Social, Governance (ESG) Framework is currently being developed and it is anticipated that this framework will be available for call off by early summer 2016. This is likely to offer a number of lots, which funds will be able to call off including voting services, governance overlay and research work.

3.4 MiFID II Impact on LGPS and Local Authorities

3.4.1 The first Markets in Financial Instruments Directive was adopted in April 2004 and came into force in November 2007. Its aim was to improve the competitiveness of EU financial markets by creating a single market for investment services and activities, and ensuring a high degree of harmonised protection for investors in financial instruments, such as shares, bonds, derivatives and various structured products. Under the current regulations LGPS funds are classified as professional investors enabling them to undertake transactions in a wide range of investments including complex ones such as hedge funds, private equity and property.

3.4.2 MiFID II is a wide-ranging EU regulation designed to improve investor protection and make financial markets safer and more transparent. It replaces MiFID and comes into effect on 3 January 2017 for all investment firms. It imposes more stringent transaction reporting and fee and charges disclosure rules on investment managers, and enforces better product governance to ensure that products are only sold to suitable investors. Retail investors can buy investments traded on public markets. But restrictions apply to complex and sophisticated investments, including those covered under the Alternative Investment Fund Managers directive (AIFMD), which includes hedge funds, private equity, property, and commodities. Under MiFID II local authorities will be classified as retail investors and because of the relationship of the local authority as the Administering Authority of the Pension Fund, the follow through is that LGPS Funds will also be classified as retail investors. In the private sector, company pension funds are primarily separate legal entities with trustee status and will therefore be unaffected by these changes.

3.4.3 Under MiFID II, all financial services firms such as banks, brokers, advisers and fund managers will have to treat LGPS funds in the same way they do individuals and small businesses. That includes ensuring that investment products are suitable for the customer’s needs, and that all the risks and features have been fully explained. Whilst recognising that this is appropriate for retail investors it also involves lots more documentation and administration for both the firm and the client, to prove to the regulator that all the steps have been taken, and as evidence in case of alleged mis-selling. Further under MiFID II, asset managers are not allowed to sell investments such as hedge funds, property and private equity to retail clients because of their complex nature.

3.4.4 LGPS Funds will be able to go through an election process to be upgraded to professional clients but it will take time and will be onerous as they will have to prove to each asset manager that they meet the strict qualitative and quantitative criteria. These include showing the requisite experience, expertise and knowledge so the funds are capable of making their own investment decisions. Although managers carry the regulatory risk, it is the funds that will have to collate the information to prove they are professional clients.

3.4.5 The qualitative criteria under MiFID II are that Funds will have to demonstrate an 'adequate assessment of the expertise, experience and knowledge of the client that gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved' This assessment 'should be performed in relation to the person authorised to carry out transactions on its behalf.'

3.4.6 The quantitative criteria - (2 of the following 3 must be satisfied):

- the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters;
- the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds EUR 500,000;
- the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.

3.4.7 The Local Government Association (LGA), DCLG, the Investment Association along with LGPS Funds are currently lobbying the Financial Conduct Authority to try to find ways of lessening the impact on local authorities and in particular LGPS Funds of the new European Directive. In addition it is hoped that transition arrangements can be put in place to ensure that Funds aren't forced into a fire-sale of current holdings once the directive comes into force in January 2017. A copy of the LGA paper issued to raise awareness of the issue to local authorities is attached as an appendix to this report for information. It is anticipated that the FCA will issue a consultation on the introduction of MiFID II and its impact on local authorities in early 2016. The FCA also presented to the London CIV Sectoral Joint Committee, which the Vice Chair of Pensions Committee attends outlining the issues for the Committee. A copy of the presentation given to the CIV is attached for information and sets out clearly the timeline of the introduction of the Directive and the issues arising.

3.4.8 With the move to pooling of local authority investments, the introduction of MiFID II could impact on how some of these vehicles are set up and the status that they would attract. The London CIV which the London Borough of Tower Hamlets Pension Fund has supported will meet the criteria of a professional investor given its FCA status as an authorised contractual scheme. However, whilst the London CIV will be classified as a Professional Investor it is unclear at this stage whether the CIV will have to undertake the same level of due diligence with its LGPS clients as a fund manager would do. In addition it is unclear whether some of the structure which could be put forward under the pooling consultation by LGPS funds would fall into the classification of professional investors.

3.4.9 At this stage the contents of this report are for information only, but to make the Committee aware of the potential ramifications of the new EU directive and to note that the Fund may face additional scrutiny and resource requirements if it is to be able to meet the professional classification. It should also be noted that this could also impact on the Council's treasury function.

3.5 Fossil Fuel Divestment Campaign

3.5.1 Over the past six months the debate on responsible investment has been in large part due to the growing movement regarding climate change and the associated fossil fuel divestment campaign.

3.5.2 Responsible investment is about managing risks and identifying opportunities. This can be achieved via the following vehicles:

- Sustainable investment – This involves considering the financial impact of environmental, social and governance (ESG) factors on investments.
- Stewardship and governance – This concerns investors acting as responsible and active owners, through considered voting of shares, and engaging with company management when required.

3.5.3 Trustees have a fiduciary duty to act in the best interests of their members, as well as acting prudently, responsibly and honestly. Within the context of these duties, which include controlling risks, they must aim to achieve the best realistic return over the long term. And for London Borough of Tower Hamlets Pension Fund this means:

- to ensure the long-term solvency of the Fund
- to ensure that sufficient funds are available to meet all benefits as they fall due for payment
- not to restrain unnecessarily the investment strategy of the Fund so that the Council can seek to maximise investment returns (and hence minimise the cost of the benefits) for an appropriate level of risk.

3.5.4 The London Borough of Tower Hamlets Pension Fund (the Fund) is a member of the Local Authority Pension Fund Forum (LAPFF).

3.5.5 LAPFF does not support divestment from fossil fuel companies but considers active engagement with companies producing fossil fuels as a productive approach to effecting change. The approach of direct and collaborative engagement contrasts with blanket divestment. Once an asset owner divests, their ability to influence both the short and longterm direction of individual companies and the national and international energy sector is severely curtailed.

3.5.6 LAPFF's engagement strategy is to push for an orderly carbon transition by requiring companies to identify and tackle carbon risks in their business models. Therefore we can say the Fund was one of the prime movers/supporters of the strategic resilience shareholder resolutions put to BP and Shell's 2015 AGMs. These resolutions were unique in that they were supported by the boards and galvanised investor support and built on a history of previous engagement with resources companies on carbon asset risk. The Fund also votes on resolutions at global AGMs seeking transparency and disclosure of climate risks and setting emission reduction targets. In this manner our view is directly communicated to individual boards.

3.5.7 It should be noted that the Fund does have an increasing level of investment in renewable and low carbon energy production and will continue to make such investments where the risk/return profile fits the pension fund's investment strategy.

3.5.8 The LAPFF has long been concerned about climate and carbon-related risks to the underlying investment portfolios of member funds and has been engaging with companies and on public policy since 2002 to address the many risks related to climate change.

3.5.9 The LAPFF's engagement strategy is to ask companies to identify and tackle carbon risks in their business models. In doing so, the Forum supports an orderly transition requiring companies to identify and tackle carbon risks in their business models.

3.5.10 For coal, oil and gas companies, particular attention is given to carbon asset risk, by promoting a low carbon transition. For oil and gas companies, the focus should be on value at risk, particularly from high cost projects and support can be given to returning capital to investors where appropriate.

3.5.11 An example of engagement is the coordination undertaken with member funds to co-file and support shareholder resolutions to both the BP and Shell 2015 AGMs on strategic resilience for 2035 and beyond. The resolutions ask the companies to report on their operational emissions management; asset portfolio resilience to the International Energy Agency (IEA)'s scenarios; low-carbon energy research and development and investment strategies; relevant strategic key performance indicators and executive incentives; and public policy positions relating to climate change.

3.5.12 LAPFF also works in cooperation with other investors and organisations to maximise the voice of asset owners including through its membership of the Aiming for An Investor Coalition, through collaborative engagement with the Investor Network on Climate Risk and as a signatory to the Principles for Responsible Investment.

3.5.13 The Principles for Responsible Investment were developed by an international group of institutional investors reflecting the increasing relevance of environmental, social and corporate governance issues to investment practices. The process was convened by the United Nations Secretary-General.

3.5.14 These principles are based on the belief that as institutional investors, they have a duty to act in the best long-term interests of their beneficiaries. In this fiduciary role, they believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). They also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with their fiduciary responsibilities, they commit to the following:

- Principle 1: To incorporate ESG issues into investment analysis and decision-making processes.
- Principle 2: To be active owners and incorporate ESG issues into our ownership policies and practices.
- Principle 3: To seek appropriate disclosure on ESG issues by the entities in which they invest.

- Principle 4: To promote acceptance and implementation of the Principles within the investment industry.
- Principle 5: We will work together to enhance our effectiveness in implementing the Principles
- Principle 6: To report on activities and progress towards implementing the Principles.

3.5.15 The Forum has also supported resolutions encouraging Chevron and Exxon to set carbon reduction targets and at Chevron to reduce capital expenditure on high cost, unconventional projects and increase the amount authorised for distribution to shareholders in the form of dividends as a climate risk hedging mechanism.

3.5.16 Encouraging appropriate regulatory frameworks is also crucial. A recent example is the LAPFF's participation in correspondence from global asset owners and managers to the G7 leaders urging stronger action by major industrial nations on emissions, and climate action. As set out in the Forum's Statement on Climate Change, LAPFF members are interested in investment opportunities afforded by a low-carbon future which increase asset diversification and provide long-term returns. LAPFF will continue to engage with companies on aligning their business models with a 2°C scenario, to push for an orderly carbon transition and to file and support relevant shareholder resolutions to companies.

3.6 Scheme Advisory Board – Separation of Pension Funds

3.6.1 The National LGPS Scheme Advisory Board was formally set up on 1st April 2015 having operated in shadow form for over a year. The purpose of the Board is to encourage best practice, increase transparency and coordinate technical and standards issues. It will consider items passed to it from the Department of Communities and Local Government ("DCLG"), the Board's sub-committees and other stakeholders as well as items formulated within the Board. Recommendations may be passed to the DCLG or other bodies. It is also likely that it will have a liaison role with the Pensions Regulator. Guidance and standards may be formulated for local scheme managers and pension boards.

3.6.2 In June this year, the Board sought bids from advisors to look at options for separation of host authority and pension fund with a report to be delivered to the Board September 2015 setting out positives and negatives and cost implications from a range of options. A link to the notice for the invitation to bid can be found here:

http://www.lgpsboard.org/images/PDF/BoardJune2015/OfS_Instructions_for_bids.pdf

3.6.3 The options for reform that the Board were asking to be considered were:

1. **Option 1 -** Stronger role for Section 151 Officer within a distinct entity of the host authority
    - Separation of financial statements and audit arrangements
    - Pension fund-specific annual governance statement
    - Specific delegations or require a senior officer to lead the function

- Group the responsibility for all LGPS related activities within one function.

2. **Option 2** – Joint Committee of two or more administering authorities
   - Delegation of full scheme manager function and all decision making to a section 102(5) joint committee
   - Employment of staff and contractual issues dealt with through lead authority or wholly owned company
   - Ownership of assets unchanged
   - Consideration be given to enshrining the structure in legislation in the form of a combined authority
3. **Option 3** - LGPS complete separation of the pension fund from the authority
   - DCLG or Treasury to create single purpose Pensions Bodies
   - Remove decision making from elected members

3.6.4 KPMG was appointed to undertake the work looking into the options for separation and due to report back to the Board September 2015. At this stage there is no indication of how they might approach this work or the likely outcome or recommendations to the Board, but clearly if any of these recommendations are put forward to DCLG and then consulted upon, they could again have far reaching implications for the LGPS and administering authorities.

4. COMMENTS OF THE CHIEF FINANCE OFFICER

4.1 The comments of the Corporate Director of Resources are incorporated in the report.

5. LEGAL COMMENTS

There are no immediate legal implications arising from this report. However due consideration will need to be given to the issues that will arise from:

the proposed pooling of pension fund investments once the consultation is underway;

the introduction of the 2nd Markets in Financial Instruments Directive which comes into effect on the 3rd January 2017;

the report being prepared by KPMG into the options for separation of host authority and pension fund which the Pensions Scheme Advisory Board has called for.

When deciding whether or not to proceed with a project, the Council must have due regard to the need to eliminate unlawful conduct under the Equality Act 2010, the need to advance equality of opportunity and the need to foster good relations between persons who share a protected characteristic and those who don’t (the public sector duty).

6. ONE TOWER HAMLETS CONSIDERATIONS

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

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

7. BEST VALUE (BV) IMPLICATIONS

7.1 To have an efficient, cost reduction platform for investment management of the Fund by pooling and collaborating is considered to be a good decision which can result in greater cost savings to the fund.

8. SUSTAINABLE ACTION FOR A GREENER ENVIRONMENT

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

9. RISK MANAGEMENT IMPLICATIONS

9.1 The rigorous robust management of LBTH Pension Fund results in better quicker and more effective decision making which can lead to better Fund performance and reduction in the contribution required from the Council towards the Fund. The monitoring arrangement for the Pension Fund and the work of the Pensions Committee should ensure that the Fund optimises the use of its resources in achieving the best returns for the Council and members of the Fund.

10. CRIME AND DISORDER REDUCTION IMPLICATIONS

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

Linked Reports, Appendices and Background Documents

Linked Report
- NONE

Appendices
- NONE

Local Government Act, 1972 Section 100D (As amended)
List of "Background Papers" used in the preparation of this report
- NONE

Officer contact details for documents:
- Bola Tobun - Investment &Treasury Manager x4733
- Mulberry House, 5 Clove Crescent E14 2BG