Non-Executive Report of the: **PENSIONS COMMITTEE** **9 March 2016**	TOWER HAMLETS
Report of: Zena Cooke, Corporate Director Resources	**Classification:** Unrestricted
The Council Responses to the Government Investment Reform Criteria & Guidance and the Consultation on the Reformation of Investment Regulations	

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

Summary

This report provides the Committee with information on the long awaited Government reform for investments and also on pooling of investments and the criteria and guidance surrounding this. At the same time the Government has also issued a consultation to amend the Investment Regulations which will help accommodate the changes being proposed for pooling.

And how this might impact on the management of the Fund's investments going forward.

Recommendations:

The Pensions Committee is recommended to:

a) Note the Investment Reform Criteria and Guidance and a response to the proposals submitted 19th February 2016, attached to this report as Appendix 1;
b) Note the consultation on Investment Regulations and a response to the proposals submitted 19th February 2016, attached to this report as Appendix 2.

1. REASONS FOR THE DECISIONS

1.1 The Pensions Committee has delegated responsibility for managing all aspects of the Pension Fund and this includes setting investment strategy for the Pension Fund. The contents of this report demonstrate that the Committee is keeping informed of potential regulatory changes to the management of the Pension Fund and in particular in relation to its role in setting investment strategy. The draft regulations will require the Fund to set out a new Investment Strategy Statement which replaces the current Statement of Investment Principles.

1.2 The draft LGPS (Management and Investment of Funds) 2016 sets out proposals which would require the Fund to issue an Investment Strategy Statement in all likelihood by the 1st October 2016 having due regard to regulations and guidance assuming that the new regulations come into force on 1st April 2016 and the Board will have to consider this in due course when carrying out the duty of securing and ensuring compliance with regulations.

2. ALTERNATIVE OPTIONS

2.1 This report highlights some fundamental changes to the way in which LGPS investments will be managed going forwards following on from the Government Criteria and Guidance along with the draft changes to the Investment Regulations. Given that Authorities are required to set out proposals as to how they will meet the Criteria and Guidance and the relatively short timescales for responding to such fundamental challenges, it is right and proper that the committee reviews and considers the issues highlighted by this report.

2.2 It is clear that the government expects all authorities in England and Wales to come forward with proposals as to how they propose to pool investments in the future and that those authorities that don't come forward with sufficiently ambitious plans for pooling could face compulsion under proposed backstop legislation contained in the draft revised investment regulations.

3. DETAILS OF REPORT

3.1 The Criteria and Guidance issued by Government along with the consultation on changes to the Investment Regulations are likely to have far reaching financial implications for all LGPS funds in England and Wales.

3.2 Pooling of investments is targeted by government to lead to significant savings in the management of LGPS assets and it is hoped in due course that additional governance benefits will also at least maintain performance if not enhance. This will obviously impact on the Fund in terms of the costs incurred in the future.

3.3 As part of the required responses to the Criteria and Governance is a requirement on authorities to provide financial information on the level of savings that can be expected from pooling of investments both in the short term and over the longer term (15 years). These estimated savings are not required for the initial proposals on pooling to be submitted by 19th February, but full financial information is required along with detailed proposals on pooling by the 15th July 2016.

3.4 London Borough of Tower Hamlets has been an active partner in the early and ongoing collaboration amongst London LGPS Funds to form the London Collective Investment Vehicle (CIV) and whilst there have been initial set up costs of £75,000 and a requirement for £150,000 Regulatory Capital Investment, these are expected to be relatively insignificant in terms of the longer term investment manager fee savings which the CIV will deliver.

3.5 Officers of the Council will work with the London CIV and other London Boroughs in order to provide realistic savings information for submission as part of the CIV's and Tower Hamlets' proposals for pooling for the 15th July 2016 submission deadline.

3.6 On 25th November 2015, the Government published its long awaited Investment Reform Criteria and Guidance (Appendix 3) alongside a consultation on new draft Investment Regulations (Appendix 5) to replace the 2009 LGPS (Management and Investment of Funds) Regulations.

3.7 This is the height of a considerable period of consultation and debate on the future for the management of pension funds in the LGPS. It started with the Hutton Review which commenced in 2010 looking at public service pension schemes and leading to the scheme changes in 2014. The government has also considered merger of LGPS funds along with requiring funds to invest the majority of assets passively and a consultation in 2014; Opportunities for collaboration, cost savings and efficiencies to which the Government received 200 responses. A Government response to this consultation (Appendix 7) has also now been issued alongside the Criteria and Guidance and draft investment Regulations.

3.8 Both the Investment Reform Criteria and Guidance and consultation on Investment Regulations seek responses firstly on how authorities plan to pool investments in outline and secondly whether the amended regulations provide sufficient flexibility for authorities to undertake pooling by 19th February 2016. Detailed proposals for pooling are then required by 15th July 2016.

3.9 Tower Hamlets has been involved in the establishment of the London CIV as way to deliver fee savings and wider governance benefits to funds in London. As such the authority is already participating in a pooled vehicle, which assuming that the funds who have already committed to the London CIV continue, means that this will meet crucial criteria for pooling including the requirement for at least £25bn of assets under management. However, given the detailed responses required of authorities and pools themselves, there remains a lot of work to do in order to be able to respond fully to Government by mid-July.

3.10 Copies of all the documentation are supplied as appendices to this report, with this report itself pulling out the key point raised in the documents.

INVESTMENT REFORM AND CRITERIA AND GUIDANCE

3.11 The Government's proposals for Investment Reform Criteria and Guidance, is attached as appendix 3 to this report. This has not been issued as a consultation as the Criteria are predetermined and authorities are now being asked to respond to how they will work together to meet the criteria and guidance laid out in the paper. Initial responses to this are required by 19th February 2016 with detailed proposals to be submitted by 15th July 2016. The initial submissions from authorities should include a commitment to pooling and a description of their progress towards formalisation of their arrangements with other authorities with authorities being able to determine whether to submit individual or joint proposals or both. The submissions in July are expected to fully address the criteria set out by government comprising:

i. for each pool, a joint proposal from participating authorities setting out the pooling arrangement in detail. For example, this may cover the governance structures, decision-making processes and implementation timetable; and
ii. for each authority, an individual return detailing the authority's commitment to, and expectations of, the pool(s). This should include their profile of cost and savings, the transition profile for their assets, and the rationale for any assets they intend to hold outside of the pools in the long term.

3.12 The Chancellor had previously indicated in his July 2015 budget that he would work with authorities to ensure that LGPS investments in England and Wales would be pooled to significantly reduce costs, whilst maintaining investment performance. The initial indications were for 5-6 pools of investments of £25-30bn and that government would come forth with criteria and guidance in the autumn.

3.13 The government's objectives are clear in the Ministerial Foreword, although authorities have questioned the reference to British Wealth Funds – pointing out that there are distinct differences between the LGPS Funds which have long-term pension liabilities to meet, versus wealth funds, which don't and have often been built from the proceeds of natural resources tax receipts:

"*Working together, authorities have a real opportunity to realise the benefits of scale that should be available to one of Europe's largest funded pension schemes. The creation of up to six British Wealth Funds, each with at least £25bn of Scheme assets, will not only drive down investment costs but also enable the authorities to develop the capacity and capability to become a world leader in infrastructure investment and help drive growth.*"

3.14 The Pensions Committee were provided with an update on progress and the expected criteria at their Meeting in November. The four Criteria set out in the paper are as foreshadowed and the government requires authorities to address how they propose to meet these criteria:

1) **Asset Pool(s) that achieve the benefits of scale** – the 90 Administering Authorities in England and Wales should collaborate to establish and invest through pools of at least £25bn of assets. Authorities are therefore now required to explain:

a. The size of their pool(s) once fully operational.
b. In keeping with the supporting guidance, any assets they propose to hold outside the pool(s), and the rationale for doing so.
c. The type of pool(s) they are participating in, including the legal structure if relevant.
d. How the pool(s) will operate, the work to be carried out internally and services to be hired from outside.
e. The timetable for establishing the pool(s) and moving their assets into the pool(s). Authorities should explain how they will transparently report progress against that timetable.

2) **Strong Governance and decision making** – The proposed governance structure for the pools should:
   a. At the local level, provide authorities with assurance that their investments are being managed appropriately by the pool, in line with their stated investment strategy and in the long-term interests of their members;
   b. At the pool level, ensure that risk is adequately assessed and managed, investment implementation decisions are made with a longterm view, and a culture of continuous improvement is adopted.

And authorities are required to explain:

i. The governance structure for their pool(s), including the accountability between the pool(s) and elected councillors, and how external scrutiny will be used.
ii. The mechanisms by which the authority can hold the pool(s) to account and secure assurance that their investment strategy is being implemented effectively and their investments are being well managed.
iii. Decision making procedures at all stages of investment, and the rationale underpinning this.
iv. The shared objectives for the pool(s), and any policies that are to be agreed between participants.
v. The resources allocated to the running of the pool(s), including the governance budget, the number of staff needed and the skills and expertise required.
vi. How any environmental, social and corporate governance policies will be handled by the pool(s).
vii. How the authorities will act as responsible, long term investors through the pool(s), including how the pool(s) will determine and enact stewardship responsibilities.
viii. How the net performance of each asset class will be reported publically by the pool, to encourage the sharing of data and best practice.
ix. The extent to which benchmarking is used by the authority to assess their own governance and performance and that of the pool(s), for example by undertaking the Scheme Advisory Board's key performance indicator assessment.

3 **Reduced costs and excellent value for money** – Proposals are required to set out how the pool(s) will deliver substantial savings in investment fees both in the near term and over the next 15 years, whilst at the same time maintaining

investment performance. The criterion goes on to emphasise the active management should only be used where it can be shown to deliver value and authorities are required to report how fees and net performance in each listed asset class compare to a passive index. As part of the proposals submitted in July, authorities should provide:

a. A fully transparent assessment of investment costs and fees as at 31March 2013.

b. A fully transparent assessment of current investment costs and fees, prepared on the same basis as 2013 for comparison.

c. A detailed estimate of savings over the next 15 years.

d. A detailed estimate of implementation costs and when they will arise, including transition costs as assets are migrated into the pool(s), and an explanation of how these costs will be met.

e. A proposal for reporting transparently against their forecast transition costs and savings, as well as how they will report fees and net performance.

4 **An improved capacity to invest in infrastructure** – Given the current low exposure to infrastructure, estimated at 0.3% compared to international comparisons of 10-15% of assets under management, the Government sees the scales that investment pools bring as offering real scope to increase the exposure to infrastructure assets. Authorities are therefore required as part of their submission to cover:

a. The proportion of their fund currently allocated to infrastructure, both directly and through funds, or “fund of funds”.

b. How they might develop or acquire the capacity and capability to assess infrastructure projects, and reduce costs by managing any subsequent investments directly through the pool(s), rather than existing fund, or “fund of funds” arrangements.

c. The proportion of their fund they intend to invest in infrastructure, and their ambition in this area going forward, as well as how they have arrived at that amount.

3.15 The government emphasises that authorities whilst forming proposals, funds should continue to manage their investment strategies and any manager appointments until new arrangements are in place. To assist authorities in developing their proposals the Government has provided a copy of PwC’s technical analysis (attached as appendix 6 to this report) and in addition strongly encourages authorities to learn from others who have already begun the journey of developing collective investment vehicles such as the London CIV and the LPFA/Lancashire venture.

3.16 Other points to note in the criteria and guidance:

i. Government expects all administering authorities to pool their investments to achieve economies of scale and the wider benefits of sharing best practice.

ii. It expects no more than six large asset pools each with at least £25bn of LGPS assets under management. There may be limited scope to allow smaller pools but only for bespoke circumstances such as a particular asset class e.g. infrastructure or other illiquid assets.

iii. The Government agrees that the democratic link between the authority and the running of the Scheme remains important and should not be removed by the pooling of investments. When developing a pool, authorities should ensure that there remains a clear link through the governance structure adopted, between the pool and the Pensions Committee.

iv. Strategic asset allocation remains with the Administering Authority but that the implementation of that strategy will be delegated to officers or the pool. Manager selection will need to be undertaken at the pool level.

v. When developing proposals, authorities need to take into consideration procedures and mechanisms to facilitate long term responsible investing and stewardship through the pool.

vi. Enacting of environmental, social and corporate governance policy (ESG) should be taken into consideration both at an individual authority and pool level and how the authority’s individual views can be reflected through the pool. In addition the Government intends to issue guidance to authorities that ESG policies should not run counter to Government policy (see investment consultation).

vii. Whilst no specific savings target from the proposals has been set, authorities are expected to come forward with estimated savings, there are clear references to the savings suggested in the Hymans Report. These include:

    a. £230m annual fee savings from passive; £190m p.a. from lower transaction costs; £240m p.a. from use of collective investment vehicles instead of “fund of funds” for illiquid assets.

    b. Reference also made to LPFA’s 75% fee savings from moving to internal management and £16m savings from shared procurements from the National Procurement Framework so far.

viii. The extent to which passive management is used will remain a decision for each authority or pool, but authorities are encouraged to keep their balance of active and passive management under review.

ix. The Scheme Advisory Board is commissioning advice to help authorities fully assess all investment costs which should be taken into account when coming forward with proposals.

x. Developing larger investment pools will make it easier to develop or acquire improved capacity and capability to invest in infrastructure. The Government believes that authorities can play a leading role in UK infrastructure and driving local growth.

3.17 The London Borough of Tower Hamlets Pension Fund has been working closely with other London Boroughs, in developing the London CIV and this will help frame the response that the authority is able to submit. The work undertaken by the London CIV has been recognised in the criteria for reform and has helped to form the debate around collective investment vehicles. Whilst recognising that London has led in this field, the criteria and guidance still require considerable resources to deliver the Government's agenda for reform.

CONSULTATION – REVOKING AND REPLACING THE LGPS (MANAGEMENT AND INVESTMENT OF FUNDS) REGULATIONS 2009

3.18 The consultation on revoking and replacing the LGPS Investment Regulations and draft LGPS (Management and Investment of Funds) Regulations 2016, are attached as appendix 4 and 5 to this report.

3.19 Amending or replacing the Investment Regulations has been under discussion for a number of years and with the requirement for pooling, this has reinforced the need to amend the existing investment regulations. The consultation proposes to relax the current regulatory framework, but to introduce safeguards. The Chancellor's July Budget indicated that measures should be introduced to ensure that those authorities who do not bring forward ambitious proposals for pooling, in keeping with the Criteria (outlined in the previous section) should be required to pool.

3.20 The consultation proposes to revoke and replace the LGPS (Management and Investment of Funds) Regulations 2009 with there being 2 areas of reform, namely:

a. A package of reforms that propose to remove some of the existing prescribed means of securing a diversified investment strategy and instead place the onus on authorities to determine the balance of their investments and take account of risk. (Proposal 1)
b. The introduction of safeguards to ensure that the more flexible legislation proposed is used appropriately and that the guidance on pooling assets is adhered to. This includes a suggested power to allow the Secretary of State to intervene in the investment function of an administering authority when necessary. (Proposal 2)

3.21 The Government is seeking views on whether the revisions will enable sufficient flexibility for authorities to determine a suitable investment strategy that appropriately takes account of risk. Further whether the proposals for safeguards being proposed and the scope for intervention by the Secretary of State will help to ensure that authorities are able to access the benefits of scales offered by pooling.

3.22 **Proposal 1: Adopting a local approach to investment** – In coming forward with this proposal the Government is seeking to deregulate and simplify the investment regulations removing a number of restrictions, e.g. the requirement for funds to ensure an adequate number of managers and removing restrictions around the choice and terms of investment manager appointments. The proposals will also see the removal of the existing schedule of limitations on investments with authorities expected instead to adopt a 'prudential' approach, demonstrating they have given consideration to the suitability of different types of investments, have appropriate diversification and risk management. A new Investment Strategy Statement will be required of Funds, replacing the current Statement of Investment Principles.

3.23 The Investment Strategy Statement which authorities will be required to prepare and publish; having taken proper advice will need to cover:

a. A requirement to use a wide variety of investments.

b. The authority's assessment of the suitability of particular investments and types of investments.

c. The authority's approach to risk, including how it will be measured and managed.

d. The authority's approach to collaborative investment, including the use of collective investment vehicles and shared services.

e. The authority's environmental, social and corporate governance policy.

f. The authority's policy on the exercise of rights, including voting rights, attached to its investments.

3.24 Authorities will be required to publish an Investment Strategy Statement no later than 6 months after the regulations come into force (expected to be 1st April 2016) and existing provisions in current regulations around restrictions will remain in force until such time as the authority publishes its first Statement.

3.25 **Proposal 1: Non-Financial Factors** – Included within the consultation is a section on non-financial factors, which it is felt important to highlight to Committee. For information, the relevant section is copied in full below:

i. The Secretary of State has made clear that using pensions and procurement policies to pursue boycotts, divestments and sanctions against foreign nations and the UK defence industry are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government. The Secretary of State has said, "Divisive policies undermine good community relations, and harm the economic security of families by pushing up council tax. We need to challenge and prevent the politics of division."

ii. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 already require administering authorities to publish and follow a statement of investment principles, which must comply with guidance issued by the Secretary of State. The draft replacement Regulations include provision for administering authorities to publish their policies on the extent to which environmental, social and corporate governance matters are taken into account in the selection, retention and realisation of investments.

iii. Guidance on how these policies should reflect foreign policy and related issues will be published ahead of the new Regulations coming into force. This will make clear to authorities that in formulating these policies their predominant concern should be the pursuit of a financial return on their investments, including over the longer term, and that, reflecting the position set out in the paragraph above, they should not pursue policies which run contrary to UK foreign policy.

3.26 **Proposal 2: Introducing a safeguard – Secretary of State Power of Intervention –** In proposing new flexibilities around investment under Proposal 1 to enable authorities to pool investments and access scale benefits, the Government is keen to ensure that such flexibilities are used appropriately. The consultation therefore proposes to introduce a power for the Secretary of State to intervene in the investment function of an Administering Authority if (s)he believes that it has not had regard to guidance and regulations. This represents the backstop legislation to which the Chancellor referred in his July budget Statement. In addition the draft power to intervene could be used to address authorities that do not bring forward proposals for pooling their assets in line with the published criteria and guidance.

3.27 **Proposal 2: Determining to intervene and process of intervention –** In reaching a decision on whether to intervene, the Secretary of State will need to consider evidence as to whether the authority has failed to have regard to the regulations or guidance issued under regulation, such evidence could include ignoring information on best practice, failing to follow investment regulations and guidance or undertaking a pension-related function poorly e.g. in respect of actuarial valuations where they are not consistent with other authority valuations. If the Secretary of State is satisfied that intervention is required, then (s)he can draw on external advice to determine what specific intervention might be necessary. Examples of types of intervention are provided in the consultation, but not limited to the following:

i. Requiring an administering authority to develop a new investment strategy statement that follows guidance published under draft Regulation 7(1).

ii. Directing an administering authority to invest all or a portion of its assets in a particular way that more closely adheres to the criteria and guidance, for instance through a pooled vehicle.

iii. Requiring that the investment functions of the administering authority are exercised by the Secretary of State or his nominee.

iv. Directing the implementation of the investment strategy of the administering authority to be undertaken by another body.

4. COMMENTS OF THE CHIEF FINANCE OFFICER

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

5. LEGAL COMMENTS

5.1 Proposed new regulations – The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (expected to come into force on the 1st April 2016) will deal a number of matters relating to local government pension funds. Under regulation 5, there will be restrictions on an administering authority borrowing money where the borrowing is likely to be repaid out of its pension fund. Regulation 7 introduces a requirement on an administering authority to formulate an investment strategy which must be in accordance with the guidance issued by the Secretary of State. The authority must take proper advice prior to formulating its strategy. The strategy replaces the statement of investment principles which an authority was previously required to produce. The strategy must include the following matters:

(a) a requirement to invest fund money in a wide variety of investments;

(b) the authority's assessment of the suitability of particular investment and types of investments;

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

(d) the authority's approach to pooling investments, including the use of collective investment vehicles and shared services;

(e) the authority's policy on how social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and

(f) the authority's policy on the exercise of the rights (including voting rights) attaching to investments.

The authority must consult any persons it considers appropriate on the contents of its investment strategy.

5.2 Regulation 8 will give the Secretary of State the power to issue a direction to an administering authority. Such a direction will be issued if the Secretary of State is satisfied that the authority is failing to have regard to guidance issued under regulation 7 – the investment strategy statement. It should be noted that Regulation 12 of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 will continue to apply to the authority until the date when the authority publishes its investment strategy statement. For the period starting on 1st April 2016 and ending on whichever is the earlier of the date when the authority publishes its investment strategy statement under regulation 7 or 30th September 2016, regulation 7 applies to an authority only to the extent necessary to enable the authority to formulate and publish its investment strategy statement.

5.3 In addition to the new regulations referred to above, the authority is now required to provide financial information to Secretary of State on the savings that can be achieved by the pooling of investments. The government has issued detailed Criteria and Guidance on investment reform and pooling of local government pension funds to which the Council has responded as required. The Council has also sent a response to the proposed draft regulations.

5.4 When making decisions regarding investment of pension funds, 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 London Borough of Tower Hamlets Pension Fund represents an asset to the Council in terms of its ability for attracting and retaining staff who deliver services to residents. A proactive approach to the adoption of a new regulation should lead to a more effective management of the Fund.

6.2 A significant element of the Council's budget is the employer's contribution to the Fund. Therefore, any improvement in the efficiency of the Fund that leads to improvement in investment performance or cost savings will likely reduce contributions from the Council and release funds for other corporate priorities.

7. BEST VALUE (BV) IMPLICATIONS

7.1 Contributing and having a better understanding of government proposals would allow a proactive and cost effective approach in embracing new regulation and guidance which should result in a more efficient process of managing the Pension 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 This will enable a timely over hauling of appropriate policy documents in order to minimise risks relating to non-compliance under the new Regulation as the council is the administering authority of the London Borough of Tower Hamlets Pension Fund.

10. CRIME AND DISORDER REDUCTION IMPLICATIONS

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

Linked Reports, Appendices and Background Documents

Linked Report

- NONE

Appendices

- Appendix 1 – LBTH Response: Local Government Pension Scheme: Investment Reform Criteria and Guidance
- Appendix 2 – LBTH Response: Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 Consultation
- Appendix 3 **-** Local Government Pension Scheme: Investment Reform Criteria and Guidance
- Appendix 4 - Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 Consultation
- Appendix 5 – Draft LGPS Investment of Funds Regulations 2016
- Appendix 6 – PwC Report: Design of the structure and governance of efficient and effective CIVs for LGPS Funds
- Appendix 7 - Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies – Consultation

Local Government Act, 1972 Section 100D (As amended)
List of "Background Papers" used in the preparation of this report

- NONE

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