Pensions CIV Sectoral Joint Committee

Item no: 5

Regulatory Capital Requirements

Report by:	Hugh Grover	**Job title:**	Chief Executive, London LGPS CIV Ltd.
Date:	21 July 2015		
Contact Officer:			
Telephone:	020 7934 9942	**Email:**	hugh.grover@londoncouncils.gov.uk

Summary

It is a requirement for the operator of an Authorised Contractual Scheme to have a sufficient level of regulatory capital ('own funds'[1]) in place at all times. This capital must be readily available (liquid or invested in near-cash assets) to ensure the ongoing viability of a company faced with an unforeseen event that might otherwise cause its insolvency and to cover the potential exposure of the company to professional liability in respect of all its activities, including the management of funds under delegated mandates.

This report presents the committee with detailed information about the regulatory capital regime and asked for the committee to agree the proposals outlined to address the regulatory capital requirement.

Recommendations

The committee is recommended to:

i. Consider the issues raised in this report;

ii. Agree to the proposal outlined in paragraph 16;

iii. Decide which of the three options outlined in paragraph 19 should be adopted, with regard to the proposal given in paragraph 20.

[1] Own funds is defined as shareholders' capital, share premium and retained profit reserves and long-term debt.

Regulatory Capital Requirements

Introduction

2. It is a regulatory requirement for a company managing and operating an Authorised Contractual Scheme (ACS) fund to have a minimum level of 'regulatory' capital (RC) that is separately identifiable and readily available (liquid or invested in near-cash assets) to ensure the ongoing viability of a company faced with an unforeseen event that might otherwise cause its insolvency and to cover the potential exposure of the company to professional liability in respect of all its activities, including the management of funds under delegated mandates. Effectively it is a reserve designed to protect investors in the fund (not investors in the company) by ensuring that the company can continue trading if faced with an unplanned liability or event that might otherwise put it out of business. While it might be argued that the nature of the CIV and its relationship with its investors (who at the outset at least are all also owners of the company) makes the need for such protection less necessary, there are no exceptions or exemptions under the regulations.
3. The issue of RC was covered in relatively broad terms in the report from the Pensions Working Group that went to Leaders' Committee in February 2014, and was subsequently described in more detail in a briefing note that went to borough officers (attached at Annex A).
4. The company was required to address RC, particularly its source and plans to ensure adequacy, in the regulatory application that was submitted to the FCA for authorisation on 26 June 2015. The Board of London LGPS CIV Ltd. considered this issue at its 12 May 2015 meeting. Further consideration was given to the matter by the London Financial Advisory Committee (LFAC), a sub-group of the Society of London Treasurers (SLT) at its meeting of 18 May, and subsequently by a full meeting of SLT on 5 June 2015. The proposals that follow are based on the outcome of those discussions and reflect the considered view of SLT.
5. There are two ways for capital to be put into a firm, debt or shareholder equity.
6. The regulator prefers RC to be injected via share capital (known as Tier one capital). With respect to debt, i.e. a subordinated loan, this could be used but as RC needs to have a level of permanency, such debt usually has to have certain characteristics for it to be recognised as RC by the regulator, i.e. it has to be long term and not required to be repaid quickly.
7. It should be noted that the injection of RC by the participating boroughs should be seen as an <u>investment</u> and <u>not expenditure</u> as it will remain as an asset of the borough and will be invested by the company in liquid assets which will generate a return – it is not intended that it will be used for day-to-day expenditure.

Discussion

8. As noted above, RC is a regulatory requirement and the regulations prescribe how the amount needed is calculated. As described in more detail in Annex A, there are three elements that determine the amount of capital required:

i) Fixed initial capital required at the point of authorisation (i.e. no funds under management) of €125,000 (approximately £100,000);

ii) A formula that applies once assets come under management. In broad terms, this formula determines that capital is required at the higher of two different numbers. The first is 25 per cent of the fixed costs of the company and the second is 2bps of the assets under management (AUM) in excess of €250mil, plus the amount at i); and

iii) An amount calculated as 1bps of AUM to cover professional liability risks, which is additional to the amount at ii).

9. This leads to the RC requirement describing a curve that varies over time and this is illustrated at Appendix A of Annex A. Based on broad assumptions about how the fund might grow over time the resulting RC requirement could be as shown in Figure 1 below. It can be seen that AUM quickly becomes the dominant factor in determining the total RC required. For clarity it should be noted that Figure 1 is based on growth projections leading to an increasing requirement for RC, the opposite effect would apply if the fund shrinks.

10. At this time, the regulations set a ceiling for RC at €10mil. As can be extrapolated from Figure 1, this would equate to around £30bn of AUM (i.e. the total estimated value of all 33 LGPS funds in London (excl. the LPFA)).

Figure 1

		Authorisation (£)	Early phase of launch (£)	By end of year 1 (£)	By end of year 2 (£)	By end of year 3 (£)
a)	Initial Capital (Base Own Funds)	100,000	100,000	100,000	100,000	100,000
b)	Fixed Overhead (25%)	310,000	310,000	310,000	380,000	390,000
c)	AUM Requirement (2 bps on AUM > £250mil)		150,000	950,000	1,950,000	2,950,000
d)	Professional Negligence (1bps of AUM)		100,000	500,000	1,000,000	1,500,000
	Total RC requirement	**100,000**	**510,000**	**1,550,000**	**3,050,000**	**4,550,000**
		= a	= a+b+d	= a+c+d	= a+c+d	= a+c+d
	TOTAL per borough**	3,500	17,000	52,000	102,000	152,000
	AUM Assumption	£0bn	£1bn	£5bn	£10bn	£15bn
	**Rounded number based on 30 participating boroughs and equal distribution					

11. The regulations require that RC is held in a readily accessible (liquid) form. This does not preclude its investment, but does lead to such investments being of a form that would be easy to access such as gilts or other cash equivalent, highly liquid assets.

12. On the basis that most (if not all) boroughs have cash on deposit and/or investments in gilts, funding the RC requirement would actually be little different from their current position, except that investment in the operator's common stock would show as an equity

investment on the borough's balance sheet rather than an investment in, say, gilts. However, the key point is that this should be seen as an investment from which a borough would benefit, that benefit being potentially in one of two forms:

i) By taking the investment return; or

ii) By leaving the return in the RC pot to reduce the need for further RC contributions as the AUM grows over time.

13. It is a requirement that the company monitors its RC position on a regular basis and takes steps to increase its RC holding if the need arises.

14. In deciding how to fund the RC requirement consideration has been given to how to balance fairness, complexity and the risk of breaching the regulations by not having sufficient RC in place (either at the outset or as RC requirements change over time). The proposal outlined below reflects the views of the London LGPS CIV Ltd. Board and SLT in terms of how to balance those considerations.

15. In considering the proposal it should be noted that the Regulator's approval is required for any action that will impact on the RC balance, and immediate withdrawal of RC funds is unlikely to be acceptable.

Proposal

16. It is proposed that:

- Each shareholding borough would be asked to contribute equal shares of the RC requirement.
- The RC would be generated through boroughs subscribing to non-voting B Shares of £1 each, to the value of the boroughs RC commitment (participating boroughs have already invested £1 each in ordinary ("A") shares, which will have the rights set out in the Articles of Association).
- The boroughs would be asked to contribute RC to the amount estimated as required by the end of year (i.e. £150,000 as shown in Figure 1.) In this way it will not be necessary to return to the boroughs for further RC for a significant period of time, and indeed may not be necessary at all if the RC investment return is allowed to accumulate in the RC account.

17. Some consideration was given to an option based on linking each boroughs RC contribution to the level of assets under management in the CIV. While at one level this would give the appearance of being 'fairer' it brings with it significant administrative issues (e.g. the need to monitor RC adequacy on a frequent (possibly daily) basis) and the challenges of rebalancing each boroughs contribution as new assets come under management and previously invested assets are redeemed. Were the company to find itself with insufficient RC there would be a requirement to self-report to the FCA for being in breach of the regulation, which at the very least would be a significant reputational issue.

18. While at one level this option being proposed might appear less 'fair' it should be noted that the quantum of RC required from each borough is relatively small in the context of what should be seen as a return making investment.

Impact of non-London LGPS funds investing

19. Some consideration needs to be given to the impact of other LGPS funds potentially becoming investors in the future and increasing the RC requirement (assuming the boroughs haven't already invested to the point that the RC ceiling (€10mil) has been reached). There would appear to be three options:

    i) Make it a requirement of investing in the CIV for any investor to contribute a cash amount (loan) to cover their specific impact on RC. Referring back to paragraph 6, any such loan would have to carry with it certain limitations in terms of permanency etc.;

    ii) Make it a requirement of investing in the CIV for any investor to contribute RC through the purchase of B Shares; or

    iii) Leave RC as the responsibility of the boroughs to cover as the owners of the company.

20. The third option might be more straightforward to administer, and would align with what would be common practice in the wider investment world – an investment firm normally covers such things as RC out of its own funds.

Recommendations

21. The committee is recommended to:

    i) Consider the issues raised in this report;

    ii) Agree to the proposal outlined in paragraph 16;

    iii) Decide which of the three options outlined in paragraph 19 should be adopted, with regard to the guidance given in paragraph 20.

Financial implications

22. There are no financial implications for London Councils.

23. Financial implications for London LGPS CIV Ltd. and its owners and investors are covered in the body of this report.

Legal implications

24. There are no legal implications for London Councils.

Equalities implications

25. There are no equalities implications for London LGPS CIV Ltd.

Annexes

Annex A Detailed note on regulatory capital

Background Papers

11 February 2014 report to Leaders' Committee
http://www.londoncouncils.gov.uk/node/22825

Annex A

Timing and quantum of regulatory capital requirements for London Councils' Operator of the Authorised Contractual Scheme

Introduction

This document sets out information as to the estimated amount and timing of the regulatory capital requirements for the Operator of the Authorised Contractual Scheme ('The Operator'). It follows on from the information set out in the Pension Working Groups report to Leaders Committee dated 11 February 2014, and specifically the information on the capital requirements of the Operator set out at paragraphs 14 to 18.

As noted in that paper, 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. Once the fund is established, expenses of the operator will be charged to the fund. 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. It is not expected that this should materially impact any return to the boroughs as it is proposed that the funds invested could be 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.

Summary

The amount of capital that will be required by the Operator will change over time. This is because there is a formula that determines the amount of capital that will be required and this formula is a function of various commercial factors such as the expenditure of the Operator and the levels of assets under management. As the activity levels of the Operator increase, so the amount of capital required will increase.

There are four important considerations that need to be addressed. These are as follows:

(i) The amount of capital that will be required and the timing by which this capital is required;

(ii) The time by which capital will be required from boroughs;

(iii) The mechanism for determining how much each borough will be required to contribute; and

(iv) The extent to which capital is impacted by profits and losses made by the Operator.

Each of these areas is considered in more detail below.

(i) <u>The amount of capital that will be required</u>

The formula for determining the amount of capital required is determined by regulation and has a number of variables. The detailed formula is set out at Appendix B. However, it is probably easiest to understand by considering how it applies to the Operator as the Operator's activities evolve over time.

The normal sequence of events in an Operator's life can be described as:

- established as an unregulated company;
- becoming authorised as a regulated Operator;
- appointed to manage an ACS fund; and
- Investors will start to invest.

Appendix A contains a graph that plots the size of the ACS against the capital requirements of the Operator and provides a link to each of the phases discussed in the body of this document.

Each of these phases in the Operator's life has a slightly different regulatory requirement and these are considered below.

Prior to the Operator being regulated there is no regulatory capital requirement and accordingly the Operator can initially be established with minimal share capital (e.g. £1 per shareholding local authority).

Once the Operator is about to be authorised it will require minimal share capital of €125,000.

Once the Operator starts to manage the ACS fund, the formula set out at Appendix B applies. In broad terms, this formula determines that capital is required at the higher of two different numbers. The first number is a function of the fixed costs of the Operator and the second number is a function (approximately 3 basis points) of the assets under management of the ACS fund.

Accordingly, once the Operator becomes a manager of the ACS fund but before there are any assets under management, the Operator will require some regulatory capital by reference to its fixed costs.

As the ACS starts to increase the amount of assets under management there will come a tipping point at which the relevant part of the formula will be a function of the assets under management rather than being a function of fixed costs. The timing of this tipping point will vary depending on the amount of fixed costs of the Operator. The technical position is set out in further detail at Appendices A and B.

(ii) The time by which capital will be required from boroughs

The regulatory capital requirements described above are minimum requirements. In deciding the actual amounts of capital to be contributed and the timing of such contributions, the specific facts and circumstances of the Operator needs to be considered. For example, it makes sense to have some margin of excess capital to deal with potential movements in investment markets. Similarly, it would be inefficient to have to continually inject new capital every time an investor marginally increases their investment in an ACS.

In relation to the Operator, the key timing points are likely to be the initial authorisation of the Operator and then the date on which the Operator goes live in terms of managing the ACS fund.

The Operator is likely to be authorised in late 2014 and accordingly at this point, regulatory capital of €125,000 will be required. On the assumption that at least ten boroughs are participating in the CIV, this would amount to a capital requirement of no more than €12,500 per borough. The regulation sets this initial amount in Euros, whereas subsequent amounts are a based on fixed costs of the Operator or the amounts of assets under management, both of which are denominated in Pounds Sterling.

The second key date is the date on which the Operator becomes the manager of the ACS fund. Although at this date there would be no assets under management and accordingly the only capital requirement would be a function of the fixed expenses of the Operator, the current working assumption is that capital would be subscribed at this point which would satisfy the regulatory capital requirements for a given level of assets under management. The logic for this approach is that once the ACS fund comes into existence, it will only be a matter of a few months before the pension funds invest into it. Accordingly, it would be more efficient to establish capital requirements at this point that anticipates the likely levels of investment rather than having to continually request additional capital as investments are made.

This approach also gives boroughs a clear expectation of the level of capital required on which they can make decisions rather than providing a more complex series of potential capital requirements with different time frames. The amount of capital required would be in the region of 3 basis points of assets under management. This means, for example, that for an expected assets size of £3bn, the capital requirement would be £900k. Accordingly, based on ten boroughs participating, the level of capital required would be in the region of £90,000 per borough. This capital is likely to be required in the first quarter of 2015. As noted above, this contribution is an investment rather than an expense as this capital would be invested in liquid assets such as gilts.

There is a maximum capital requirement of around €10m.

(iii) The mechanism for determining how much each borough will be required to contribute.

It will be important that the requirement to invest capital in the Operator is spread fairly across participating boroughs. The potential recommendation in this regard will depend on a number of factors such as how many boroughs choose to participate initially in the ACS, together with the likely quantum of assets to be invested in the fund. Any approach will need to take into account the relative size of potential investments from different boroughs together with the possibility that new boroughs may participate over time and existing boroughs may increase or decrease their investments in the ACS fund. This will be considered by the Pensions Working Group as part of the next phase of the project. It is expected that over time the capital contribution required from the borough will be in proportion to the level of assets that each borough has invested.

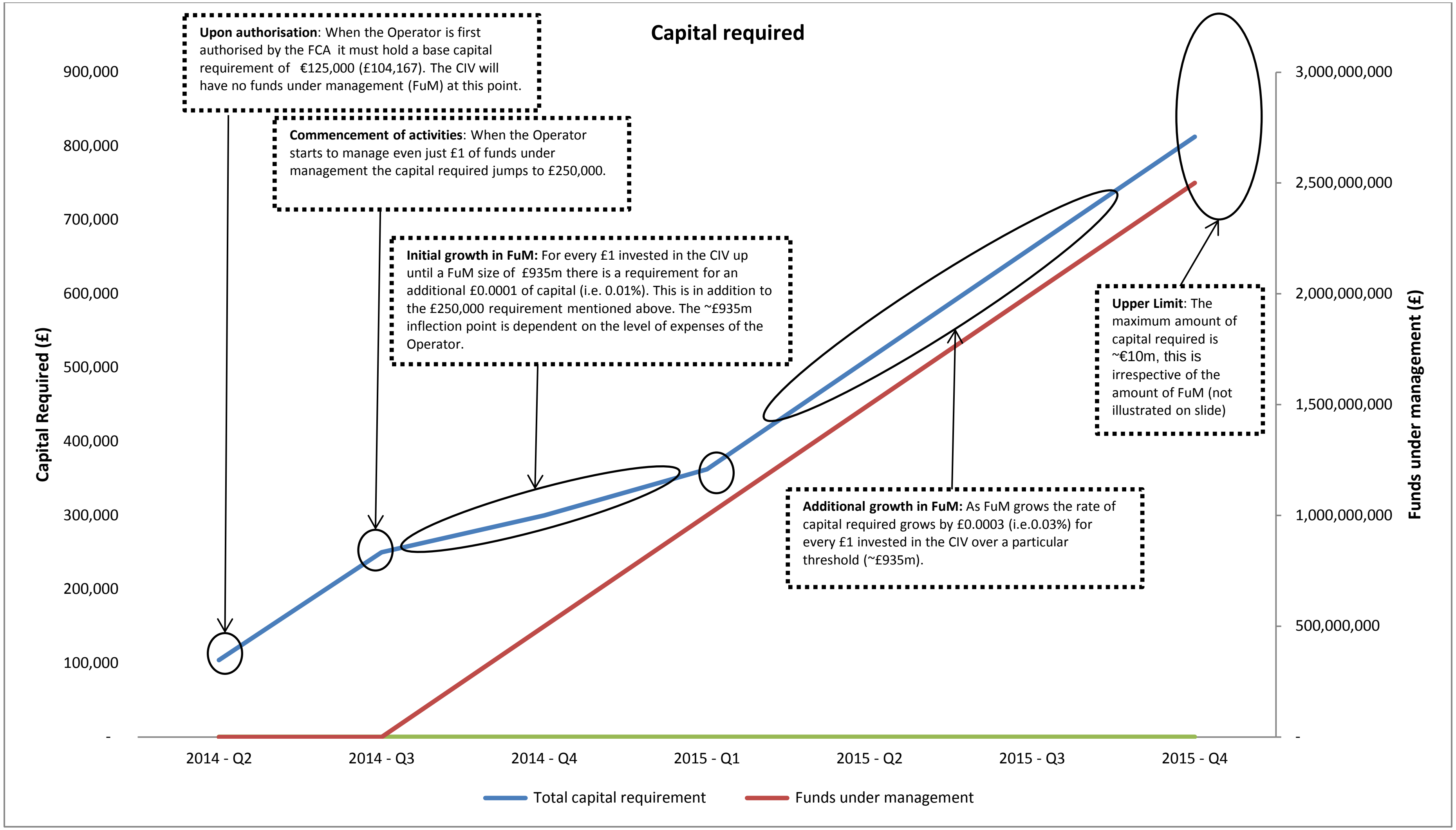
One of the over-arching principles of the ACS is that boroughs should be free to disinvest from the ACS as they choose. In this regard, the process by which boroughs can have any ‘excess’ capital returned to them is being considered. The intention would be that following a disinvestment, capital would be returned, but it is necessary to consider regulatory restrictions that serve to protect the ACS and operator having regulatory capital withdrawn indiscriminately at the sole discretion of investors.

(iv) The extent to which capital is impacted by profits and losses made by the Operator

It is not expected that over time the Operator will make any profits or losses. It will charge a fee to the fund to cover its operating costs. Depending on timing, there may be an initial loss, and then conversely a small profit at a later date, however over time minimal net profit is expected to arise. To the extent that initially cash paid out from total expenses are higher than income received / accrued, then additional capital may be required and this will be factored into the initial calculations in due course.

In the early months, it is expected that expenses of the Operator will exceed revenues. The intention is that these costs will ultimately be borne by investors in the fund in a manner which results in a fair apportionment and such that they are not unfairly borne by the initial shareholders of the Operator.

Appendix A – Graphical illustration



Appendix B: Regulatory capital under AIFMD for a Collective Portfolio Management Firm (CPM firm)

Introduction

This Appendix sets out information as to the regulatory capital that the Operator of an Authorised Contractual Scheme (Operator) would be required to hold under the Alternative Investment Fund Managers Directive (AIFMD). Our working assumption is that the Operator will be a full-scope UK AIFM because the Authorised Contractual Scheme (ACS) will be above €500m. We expect that Operator will be a Collective Portfolio Management firms (CPM), which means that you will not be providing services under the Markets in Financial Instruments Directive (MiFID). CPM firms are subject to IPRU (INV) chapter 11 and this note summarises its requirements in relation to the capital the Operator will need to hold.

This note focuses on the quantity of capital that the Operator will need but not its constituent parts i.e. share capital, subordinated loans, perpetual preference share capital, etc. In general the capital will need to be comprised of Tier 1 / Tier 2 capital (Appendix B). If subordinated loans or perpetual preference share capital meet certain conditions they can be included as Tier 2 capital, but only up to a maximum of 50% of Tier 1 capital, which broadly speaking means ordinary shares, retained earnings and share premium accounts.

Summary of provisions of Chapter 11 of IPRU-INV

1. *Initial authorisation* base capital requirement

Term	Requirement	IPRU-INV
Base capital requirement	**When a CPM firm first receives authorisation** it must hold initial capital of no less than the applicable base capital requirement. The Operator's base capital requirement will be €125,000.	11.2.1R(1), 11.3.1R(1)

2. *On-going* own funds and liquid assets requirement

Term	Requirement	IPRU-INV
Overarching	The Operator must maintain **at all times Own Funds** which equal or exceed the higher of (A+B) or C, plus D (see additional definitions, highlighted in bold, on next page) and **Liquid Assets** which equal or exceed the higher of (B) or C, plus D.	11.2.1(2) & (3)
A – Base capital requirement	The base capital requirement (i.e. €125,000)	
B - FuM requirement	0.02% of the amount by which the **funds under management** exceed €250,000,000.	11.2.1(2)a(i), 11.3.2R
C – Fixed overhead requirement	One quarter (13/52) of the Operator's **relevant fixed expenditure**.	11.2.1(2)a(ii), 11.3.3A EU
D – Professional negligence requirement	In addition the Operator must also hold **own funds** to cover professional liability risks set out in article 12 of the AIFMD level 2 regulation. This can be done in two ways, either via an insurance contract (where there will be no own funds requirement for the Operator) or via additional own funds. If the Operator holds additional **own funds** rather than enter into insurance contract the requirement is to hold additional **own funds** at least equal to 0.01% of the value of the **portfolios of AIFs managed**. If you wanted to instead have a contract of insurance, you will need to ensure it addresses the risks set out in IPRU-INV 11.3.12 EU.	11.2.1R(2)b, 11.3.11 G, 11.3.12 EU 11.3.14 EU

Term	Definition	IPRU-INV
Own funds	Own funds means the sum of Tier 1 capital and Tier 2 capital in accordance with the Capital Requirements Regulation. A very brief summary of Tier 1 capital is set out in Appendix B below.	FCA Glossary
Liquid Assets	Liquid Assets are: • readily convertible to cash within one month; and • Have not been invested in speculative positions. Examples of liquid assets include cash, readily realisable investments that	11.3.17R, 11.3.18 G

	are not held for short-term resale, and debtors. Other assets may also meet the definition but this will need to be assessed on a case by case basis.	
Funds under management	The sum of the absolute value of all assets of all funds managed by the firm shall be the sum of the absolute value of all assets of all AIFs managed by the AIFM, including assets acquired through use of leverage, whereby derivative instruments shall be valued at their market value. This includes funds where the firm has delegated the management function but excludes funds that it is managing as a delegate.	FCA Glossary (as proposed by FCA Quarterly Consultation)
Relevant fixed expenditure	*Calculation of relevant expenditure*: this should be in accordance Supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for Own Funds Requirements for Investment Firms based on Fixed Overheads. See page 10 of the RTS	11.3.3A EU
portfolios of AIFs managed	*Calculation of portfolios of AIFs managed:* The value of the portfolios of AIFs managed shall be the sum of the absolute value of all assets of all AIFs managed by the AIFM, including assets acquired through use of leverage, whereby derivative instruments shall be valued at their market value. This should be recalculated at the end of each financial year i.e. for FY14 you would use the portfolio of AIFs as at the end of FY 13 as your calculation base.	11.3.14 EU