Pensions CIV Sectoral Joint Committee

Item no: 4

National Pooling Update, the Scheme Advisory Board and MiFID II

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Summary: Mr Jeff Houston (LGA Head of Pensions and Scheme Advisory Board Secretary) has been invited to attend the Committee to provide an update on the work that he is doing at a national level. His background report is attached; he will present this at the meeting and take questions.

Recommendations: The committee is recommended to note the contents of this report.

London CIV - National pooling and Scheme Advisory Board update

Asset pooling

1. Following meetings with the Local Government Minister late in 2016 eight asset pools have been given the go-ahead subject to any caveats included in their letters.
2. The eight pools are as shown below. There are a number of variations of pool structures each with different mixes of unitised funds, bundled mandates and a few segregated mandates but all will have an FCA authorised company at their heart.

Name of Pool	Funds	Assets (£bn)
London CIV	Established for the 33 LGPS funds administered by London's 32 boroughs and the City of London Corporation,	25
Northern Pool	West Yorkshire, Greater Manchester and Merseyside	35
Central	Cheshire, Leicestershire, Shropshire, Staffordshire, West Midlands, Derbyshire, Nottinghamshire, Worcestershire	34
Brunel	Avon, Cornwall, Devon, Dorset, Gloucester, Somerset and Wiltshire, Oxfordshire, Buckinghamshire and the Environment Agency Pension Fund.	23
ACCESS	Northamptonshire, Cambridgeshire, East Sussex, Essex, Norfolk, Isle of Wight, Hampshire, Kent, Hertfordshire, West Sussex and Suffolk.	34
Wales	Carmarthenshire, Cardiff, Flintshire, Gwynedd, Powys, Rhondda Cynon Taff, Swansea, and Torfaen.	13
Border to Coast	Cumbria, East Riding, Surrey, Warwickshire, Lincolnshire, North Yorkshire, South Yorkshire, South Yorkshire Passenger Transport Pension Fund, Tyne & Wear, Durham, Bedfordshire, Northumberland and Teesside.	36
LPP	Lancashire, Berkshire and the London Pension Fund Authority	13

3. Target is for legal structures to be created by April 2018 with transition of assets to follow over a reasonable period of time. Estimated savings once fully operational are £200m per annum
4. Current work is focused on creating legal structures, recruiting to the pool operators and designing funds and mandates to be offered.
5. Concern continues to focus on timescales and the motivation behind the government's wish for greater infrastructure investment. Options for infrastructure vehicles are being developed by an officer Cross Pool Collaborative Group (CPCG)
6. The SAB have taken of stance of assisting on cross pool matters and creating effective communication channels with government but will not be pushing any particular pool structure or infrastructure vehicle over any other.

Valuations

7. Early indications are that deficits across the scheme have stabilised and in some cases reduced with average funding ratios estimated to rise from 79% in 2013 to the mid/high 80's in 2016. However future service costs have risen due to

anticipated lower returns which has mitigated any benefits to employer contribution rates from lower deficits.

8. Contribution rates will therefore remain high (average is 25% of payroll) and employers may well raise questions around the affordability of the scheme and seek ways to reduce participation.
9. In responsive to questions raised by some councils the SAB is currently seeking QC's opinion on the vires for councils to offer schemes other than the LGPS. This advice will also set out the potential legal and practical challenges for councils if such vires exists.

Deficits and employer covenants

10. The SAB will be investigating the possibility of councils making use of capital receipts to reduce their LGPS deficit by regulations under section 11 or guidance under section 15 of the Local Government Housing Act 2003.
11. If allowed to do so such a transfer could immediately reduce the level of interest payable on the deficit and the contributions currently being paid to meet it. In most cases the return being achieved on capital receipts are significantly below the potential revenue benefit of paying down the deficit.
12. The SAB is also commencing a work stream to investigate and develop options to improve the covenant and/or manage the exit of those employers who do have central or local tax backing. This objective of this work would be to minimise the risk of such employers leaving the scheme without meeting their deficits which would then fall back onto the tax payer backed employers.

Academies

13. The SAB commissioned PWC to investigate the issues for the LGPS brought about by increasing academisation. Non-teaching staff of currently 7000 academies and MATs are members of the LGPS
14. Should all 20,000 schools convert to academy trusts it is estimated that some £35b of liabilities will be contained in that sector.
15. The work stream is seeking to manage the transfer of staff and the increasing number of employers while minimising the risk of those liabilities falling back on the councils should trusts close.
16. The Chair of SAB (Cllr Roger Phillips) met with both the Local Government and Education ministers on the subject in late March and a preferred approach of retaining academies within the LGPS was agreed. Officials from SAB, DfE and DCLG will now progress in developing options within that approach.

Cost management

17. The SAB operates a cost management process for the scheme alongside that operated by HM Treasury.
18. The process is designed to measure increases in scheme costs attributable to members (for example longevity, use of 50/50 section etc.) and recommend benefit changes if necessary
19. Early indications are that such costs will have increased by just over 1% of payroll and therefore it is anticipated that the SAB will be making recommendations to alter benefit structures later this year.

Investment fee transparency

20. The SAB are in the process of launching a voluntary code of transparency for asset managers to assist authorities in meeting the CIPFA requirement to report costs on a transparent basis.

21. Progress is already being made by authorities on an individual basis resulting in reported costs rising from the £450m in 2014 to £780m in 2015. However significant resource is having to be deployed to identify these costs.
22. Asset managers signing up to the Code will agree to provide fully transparent costs on a standard template either quarterly or annually which will ease the identification and allocation of these costs. Once fully in place it is anticipated that reported costs will be well over £1b per annum across the scheme.

MiFID II

23. On 1st January 2018 local authorities will be reclassified by the Financial Conduct Authority (FCA) from professional to retail investors. This will significantly reduce the firms, asset classes and vehicles available to authorities both for pension fund and treasury management investment.
24. Retail clients can elect for professional status however firms must ensure the client meets a number of tests. These tests do not reflect the decision making processes in authorities and therefore need to applied differently
25. We believe that firms should be able to make a collective assessment of a local authority client's knowledge, experience and understanding of risk (the qualitative test) however the test states that a 'person' should be assessed.
26. Clients must also have a portfolio of at least £15m (LGPS and TM counted separately) and either have performed a significant number of transactions or have worked for 12 months in the sector (the quantitative test) with this latter element referring to an individual. We would prefer that either this is amended to include reference to advisors or a fourth criteria is added referencing the authorities status as a public service pension scheme manager.
27. There is also a serious issue around assets held after January 2018 if the opt up is not complete. One view is that a firm's overriding duty of 'best interest of the client' would prevent termination of relationships however some asset managers are not convinced that approach best manages their risk.
28. Best case is an amended opt up test that enables 89 pension funds to elect for professional status with over 300 managers before January 2018. Worst case is that opt up is not complete or firms refuse due to the wording of the tests and LGPS assets are disposed of in a fire sale.
29. We have the support of DCLG, HMT and Number 10 to find a solution and recent discussions with FCA have been positive. However nothing can be confirmed until May and the SAB would consider taking legal advice on what, if any, basis there would be to challenge FCA if the tests are not amended.
30. Finally the impact of MiFID on LGPS asset pools will require clarification. There is a good case under existing legislation for authorities to retain access to regulated fund structures (such as those currently available from or proposed by the pools) despite the reclassification in MiFID. Legal advice is currently being sought to confirm this view.

Exit payment reform

31. There are three elements to exit payment reform the timing of all of which are uncertain which is causing serious delays and disruption to planned reorganisations across the sector.
32. Exit payment recovery will require the repayment of all or part of a termination payment (including pension strain costs) were an individual who was on £80k or more returns to employment in any part of the public sector. Actual regulations have been expected since late last year

33. Exit payment cap will prevent termination payments (including pension strain costs) exceeding £95k. Draft regulations with guidance on possible waivers by full council have been expected since late last year. As agreed at LGPC we will be pushing for choice for individuals who are capped to take cash and a deferred pension in lieu of a reduced pension
34. Exit payment further reform will cap severance payments at 15 months for those not eligible for an immediate pension. For those who are eligible no non statutory severance will be payable and the amount available for pension strain will be reduced by any statutory redundancy payment. Consultation by DCLG is expected any day
35. Board officials have been maintaining a dialogue with officials in HMT, DCLG and DfE and are pushing hard for progress.

Jeff Houston

LGA Head of Pensions and Scheme Advisory Board Secretary

31st March 2017