SUPERANNUATION FUND COMMITTEE

Friday, 5th February, 2016

10.00 am

Medway Room, Sessions House, County Hall, Maidstone

Kent County Council
kent.gov.uk

AGENDA

SUPERANNUATION FUND COMMITTEE

Friday, 5th February, 2016 at 10.00 am
Medway Room, Sessions House, County Hall, Maidstone

Ask for: **Denise Fitch**
Telephone: **03000 416090**

Please note: that the unrestricted part of this meeting may be filmed by any member of the public or press present.

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UNRESTRICTED ITEMS

(During these items the meeting is likely to be open to the public)

A. COMMITTEE BUSINESS

A1 Substitutes

A2 Declarations of Interests by Members in items on the Agenda for this meeting.

A3 Minutes - 6 February 2015 (Pages 5 - 10)

A4 Motion to exclude the Press and Public

That under Section 100A of the Local Government Act 1972 the press and public be excluded from the meeting for the following business on the grounds that it involves the likely disclosure of exempt information as defined in paragraph 3 of part 1 of Schedule 12A of the Act.

EXEMPT ITEMS

(During these items the meeting is likely NOT to be open to the press and public)

B. MATTERS FOR REPORT/DECISION BY THE COMMITTEE

B1 YFM Equity Partners

B2 Fund Structure (Pages 11 - 18)

<u>UNRESTRICTED ITEMS</u>

(During these items the meeting is likely to be open to the public)

C. MATTERS FOR REPORT/DECISION BY THE COMMITTEE

C1 Local Government Pension Scheme Pooling Proposals (Pages 19 - 52)

C2 Pension Fund Custody Services Review (Pages 53 - 56)

C3 Admissions to the Fund (Pages 57 - 60)

C4 Date of next meeting

The next meeting of the Committee will be held on 18 March 2016 at 10.00am

Peter Sass
Head of Democratic Services
03000 416647

Thursday, 28 January 2016

In accordance with the current arrangements for meetings, representatives of the Managers have been given notice of the meeting and will be in attendance for Item B1.

KENT COUNTY COUNCIL

SUPERANNUATION FUND COMMITTEE

MINUTES of a meeting of the Superannuation Fund Committee held in the Medway Room, Sessions House, County Hall, Maidstone on Friday, 6 November 2015.

PRESENT: Mr J E Scholes (Chairman), Mr D S Daley (Vice-Chairman), Cllr J Burden, Cllr P Clokie, Mr D Coupland, Mr J A Davies, Cllr N Eden-Green, Mr T A Maddison, Mr R A Marsh, Mr R J Parry, Mr S Richards, Mr C Simkins, Mrs M Wiggins and Cllr L Wicks.

ALSO PRESENT: Miss S J Carey, Mr A D Crowther and Mr M E Whybrow

IN ATTENDANCE: Ms B Cheatle (Pensions Manager), Ms D Fitch (Democratic Services Manager (Council)), Ms A Mings (Treasury & Investments Manager), Mr S Tagg (Senior Accountant Pension Fund), Mr N Vickers (Head of Financial Services) and Mr A Wood (Corporate Director Finance and Procurement).

UNRESTRICTED ITEMS

139. Membership
(Item A2)

The Committee noted that Mr Crowther was no longer a member of the Committee and that there was currently one vacant unallocated seat on this Committee.

140. Minutes
(Item A4)

RESOLVED that the minutes of the meeting held on 28 August 2015 are correctly recorded and that they be signed by the Chairman.

141. Motion to exclude the Press and Public
(Item A5)

RESOLVED that under Section 100A of the Local Government Act 1972 the press and public be excluded from the meeting for the following business on the grounds that it involves the likely disclosure of exempt information as defined in paragraph 3 of part 1 of Schedule 12A of the Act.

EXEMPT ITEMS

142. Sarasin
(Item B1)

(Mr Boucher and Mr Talbot-Rice were present for this item)

(1) The Chairman welcomed Mr Boucher and Mr Talbot-Rice to the meeting. He invited them to present their report on the global equity mandate which they had managed on behalf of the Kent Fund since March 2014 and to answer questions from Committee members.

(2) The Chairman reminded Mr Boucher and Mr Talbot-Rice that the Committee expected its fund managers to at least achieve the benchmark for 2 out of 3 years and had withdrawn funds from managers if this was not achieved.

(3) RESOLVED that the presentation and the responses to the Committee's questions be noted.

(Mr Boucher and Mr Talbot-Rice left the meeting after this item.)

143. M & G
(Item B2)

(Mr Rhodes and Ms Haughey were present for the item)

(4) The Chairman welcomed Mr Rhodes and Ms Haughey to the meeting. He invited them to present their report on the global equity mandate which they had managed on behalf of the Kent Fund since October 2013 and to answer questions from Committee members.

(5) The Chairman reminded Mr Rhodes and Ms Haughey that the Committee expected its fund managers to at least achieve the benchmark for 2 out of 3 years and had withdrawn funds from managers if this was not achieved.

(6) RESOLVED that the presentation and the responses to the Committee's questions be noted.

(Mr Rhodes and Ms Haughey left the meeting at the end of this item.)

UNRESTRICTED ITEMS

144. Committee Membership
(Item C1)

(1) Mr Vickers reminded the Committee that it had received a report on proposed changes to its membership at its last meeting. As requested the report for consideration updated the Committee following the Head of Democratic Services' reconsideration of proposed changes in the Committee membership.

(2) Councillor Wicks expressed his disappointment that the review of voting rights of the Medway Council representative would not take place until 2017.

(3) RESOLVED that:

(a) the Committee's membership remain unchanged; and

(b) voting rights for the Medway Council representative be reviewed after the May 2017 County Council election; and

(c) the current District Council representation remain unchanged and if one of the existing representatives is no longer eligible to be a representative or steps down the Kent Leaders Group be asked to nominate a replacement.

145. Fund Position Statement
(Item C2)

(1) Mr Vickers presented a summary of the Fund asset allocation, performance and associated performance issues.

(2) The Committee were informed that the Kent Pension Fund had won the LGC award for Investment in the "Best Return on Property" category, this award was displayed at the meeting.

(3) The Committee discussed the lobbying by organisations against fossil fuel investments by Local Government Pension Scheme funds. Reference was made to the response that had been made available to KCC Committee Members which clearly set out the Committee's overriding fiduciary responsibility to its current and future pensioners. Officers undertook to share this response with non-KCC Committee members on request and to post an official response on the website for reference. It was noted that the most appropriate time for this matter to be considered by the Committee would be as part of the Pension Fund Strategy.

(4) Mr Vickers undertook to provide Mr Simkins with details of how much of the 8.8% return referred to in paragraph 4 (3) of the report was due to dividends received as opposed to movements in stock valuations.

(5) RESOLVED that:

(a) the Fund Position be noted; and

(b) no changes be made to asset allocation or investment managers; and

(c) an written update from M&G be submitted to the Committee at the February or March 2016 meeting; and

(d) the position on fossil fuels be noted; and

(e) the position on custody be noted; and

(f) an additional £20m be invested in the M&G global equity fund to be funded from the sale of John Laing shares and from the State Street UK Equities fund.

146. LGPS Pooling Proposals
(Item C3)

(1) Mr Vickers introduced a report which gave an update on the recent Government announcements and local authority work streams in relation to the Local Government Pension Scheme (LGPS) pooling proposals. He emphasised that this consultation was not about amalgamating LGPS funds but would enable investment with a number of other funds.

(2) RESOLVED that:

(a) officers be authorised to participate in ongoing discussions with other Funds without making any commitment, and these discussions to be fully reported to the Committee.

(b) participation in the National LGPS passive equity framework tender process be endorsed.

(c) authority for the preparation of a response to any formal consultation document from DCLG on these proposals be delegated to the Corporate Director of Finance and Procurement in consultation with members of the Committee.

147. Fund Employer Matters
(Item C4)

(1) Officers reported on Fund employers, applications to join the Superannuation Fund and a number of admission matters.

(2) RESOLVED that:

(a) the admission to the Kent County Council Superannuation Fund of Agilisys Limited be approved; and

(b) the admission to the Kent County Council Superannuation Fund of Invicta Telecare trading as Centra Pulse be approved; and

(c) the admission to the Kent County Council Superannuation Fund of Cater Link Limited (re Dover Grammar School for Boys) be approved; and

(d) an amended agreement be entered into with Project Salus re Youth Services; and

(e) an amended agreement be entered into with Project Salus re Kent Safe Schools; and

(f) an amended agreement be entered into with MyTime Active; and

(g) an amended agreement be entered into with Fusion Lifestyle Limited; and

(h) a termination agreement be entered into with Rochester Care Home Limited (re Robert Bean Lodge); and

(i) a termination agreement be entered into with APCOA Parking UK Ltd;

(j) a termination agreement be entered into with Caterlink Limited (re Upton Junior School); and

(k) the Chairman sign the minute of today's meeting relating to recommendation (a) to (c) and (h) above at the end of today's meeting; and

(l) that once legal agreements have been prepared for (a) to (j) above, the Kent County Council seal be affixed to the legal documents.

148. Dates of meetings in 2016/17
(Item C5)

The Committee noted the following dates for meetings in 2016 and up until May 2017::

- 5 February 2016
- 18 March 2016
- 24 June 2016
- 26 August 2016
- 4 November 2016
- 10 February 2017
- 24 March 2017

All meetings would start at 10.00am in the Medway Room, Sessions House, County Hall, Maidstone

By virtue of paragraph(s) 3 of Part 1 of Schedule 12A
of the Local Government Act 1972.

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of the Local Government Act 1972.

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By: Chairman Superannuation Fund Committee
Corporate Director of Finance & Procurement

To: Superannuation Fund Committee – 5 February 2016

Subject: **LOCAL GOVERNMENT PENSION SCHEME POOLING PROPOSALS**

Classification: Unrestricted

Summary: To update on the LGPS pooling work and seek decisions on pool membership and a response to DCLG's consultation paper.

FOR DECISION

INTRODUCTION

1. This report updates the Committee on developments since the last meeting on LGPS pooling. The proposals published by the Government in November 2015 present the most radical changes to the management of the LGPS since it was first established. It is clear that the Government is absolutely committed to the pooling proposals and so our task is to influence them as far as we can to ensure the proposals are sensible and position ourselves to best protect the interests of the Kent Fund moving forward.

LGPS INVESTMENT REFORM CRITERIA AND GUIDANCE

2. Given the importance of the document the DCLG paper is attached in full in Appendix 1.

3. The main issues are:

   (1) Six "British Wealth Funds" (multi asset pools for the purpose of this report) are to be established each with assets of at least £25bn.

   (2) There will be governance arrangements at pool level involving members to oversee the pool investments.

   (3) The target date for establishing the pools is 1 April 2018. We envisage that existing mandates would transfer and after that date processes would commence over an extended period to move funds into new mandates.

(4) The paper states that "backstop legislation that would require those administering authorities who do not come forward with sufficiently ambitious proposals to pool their assets with others". This is a very clear statement of intent from Government, that pooling will happen.

(5) There will be some investments such as close ended funds which will not be included in the pooling arrangements.

(6) Direct Property is excluded and this is a major move from DCLG's initial position and is the right answer from an investment perspective.

(7) The proposals leave all the other responsibilities of this Committee unchanged. This Committee will still decide which assets the Fund invests in and all other issues related to the management of the Fund.

(8) Greater investment in Infrastructure.

4. Initial responses are required by 19 February and full costed responses by 15 July.

POOLING OPTIONS

5. At the last Committee meeting it was agreed that the Head of Financial Services should participate in discussions with other Funds. The Chairman, the Deputy Leader and Cabinet Member for Finance & Procurement and the Corporate Director of Finance and Procurement have been kept fully informed of these discussions. All discussions have emphasized that decisions on the way forward are for this Committee.

6. Hymans Robertson had already facilitated a working group of around 25 non-London funds including the largest LGPS funds and a number of County Council funds. Project Pool had a formal structure and a number of sub-groups and the Head of Financial Services participated in the high level pooling workstream. A report should be published before the Committee meeting and this will represent the group of Funds views on how pooling can best be implemented.

7. This work showed that Funds are coming at the pooling issue from many directions and with many different objectives. In the Hyman's work frequent reference was made to the need for Funds to be "like minded" and this will be an issue that we return to.

8. In summary the main findings of the Project Pool work are:

(1) Preferred option multi-asset pools formed by region and like minded group.

(2) For most asset types, regional pools may give sufficient size to get the majority of scale benefits / fee reductions.

(3) Regional or like minded groupings also give individual funds more involvement in the governance of pools.

(4) For Infrastructure a national pool may be the best answer.

(5) Savings will be exceeded in the early years by the costs of setting up the pools and then by the potentially very large transaction costs.

9. Whilst the Hymans work concentrated on the "what" of pooling individual Funds seem to move very quickly to the "who". This is not a helpful emphasis and it is one which reflects the different agendas Funds have. The main groupings to emerge are:

(1) London Collective Investment Vehicle (CIV) (£24bn) – 31 London Boroughs have been working on this project for the last 2 years. It is seen as the way forward on pooling for London Boroughs. To date this has been a voluntary project but it will become mandatory under the pooling proposals.

(2) M62 (£50-60bn) – dominated by some very large funds including West Yorkshire, Greater Manchester and Merseyside. Includes a large amount of internal management.

(3) Central (35-£40bn) – Midlands funds including the very large West Midlands Fund.

(4) ACCESS (£30-38bn) – Central, Eastern and Southern shire county funds.

(5) South West (£20-24bn) – South West Funds including the Environment Agency who have been working together and have a strong ESG focus.

(6) Border to Coast (£13-17bn) – a disparate geographical group consisting of Surrey, Cumbria, East Riding and Lincolnshire.

(7) London Pension Fund Authority / Lancashire (£12-16bn) – apparently seeking to set up an in house investment management business and sell services to other funds.

(8) Wales (£15bn) – a logical geographical grouping but too small to meet Government requirements.

10. The Head of Financial Services will give an assessment of these options at the meeting. From his discussions with Funds it was clear that by far the best fit for Kent was the ACCESS group and the Chairman, the Deputy Leader and Cabinet Member for Finance & Procurement and the Corporate Director of Finance and Procurement agreed that subject to the decision of the Committee that Kent should enter into more detailed discussions with this group. At the current time the core members are West Sussex, Essex, Suffolk, Norfolk, Cambridgeshire and Northamptonshire. A number of other Funds have been attending the meetings but have taken no final decision – Hampshire, East Sussex, Hertfordshire and Bedfordshire.

11. The recommendation to work with ACCESS is based upon:

    (1) A genuine "like minded" approach and commitment to work collaboratively.

    (2) Similar investment strategies and a significant level of overlap of investment managers.

    (3) Currently no internal investment management activity. This has been a difficult issue in discussions with 8 of the larger funds in the Midlands and North very committed to internal management which others find highly unconvincing.

    (4) All County Council Funds with no standalone authorities.

    (5) No "agendas" such as setting up investment management business to sell to other Funds.

    (6) No one dominant Fund in terms of size.

    (7) Some geographical rationale which will assist in holding meetings and doing business.

12. If pooling is to happen the Fund needs to exercise the greatest influence that it can over how the pool operates. This is best done through working with "like minded" funds and reaching the £25bn requirement with the least number of participants. The ACCESS group seems to offer the Fund the best opportunity.

13. If the Committee agrees to participate in the ACCESS group we will then start an intensive period to have fully costed proposals to meet the 19 July deadline for responding to DCLG.

14. Beyond that there are very substantial issues for the pool to agree including:

    (1) Governance arrangements – one vote, one fund or weightings to reflect size. As the ACCESS group currently stands the main contributions to the cost savings that all member funds will achieve will be Kent and Essex representing 40% of the pool's assets.

(2) Legal requirement – it will be highly complex to set up Financial Conduct Authority approved investment vehicles which assets can be transitioned into for 1 April 2018. Evershed's presented to ACCESS officers and achieving the most efficient investment vehicles will be a very significant task.

(3) Advisers – investment consultants and legal advisers primarily. These need to be properly procured and the costs are likely to be significant with little in the way of compensating savings at Fund level.

15. Committee is requested to approve expenditure on professional advisers which will be reported to each meeting.

RESPONSE TO DCLG

16. A draft response is attached in Appendix 2 which does seek to be a positive one, focusing on where we may be able to influence DCLG in how the proposals develop.

RECOMMENDATIONS

17. The Committee is asked to:

(1) Agree to work on the basis that ACCESS group is the preferred option.

(2) Authorise expenditure on professional advisers.

(3) Agree the response to DCLG.

Nick Vickers
Head of Financial Services
Tel: 03000 416797
E-mail: nick.vickers@kent.gov.uk

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Department for Communities and Local Government

Local Government Pension Scheme: Investment Reform Criteria and Guidance

November 2015
Department for Communities and Local Government

This document/publication is also available on our website at www.gov.uk/dclg

If you have any enquiries regarding this document/publication, complete the form at http://forms.communities.gov.uk/ or write to us at:

Department for Communities and Local Government
Fry Building
2 Marsham Street
London
SW1P 4DF
Telephone: 030 3444 0000

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Ministerial Foreword

At the summer Budget 2015, the Chancellor announced our intention to invite administering authorities to bring forward proposals for pooling Local Government Pension Scheme investments, to deliver significantly reduced costs while maintaining overall investment performance.

We have been clear for some time that the existing arrangements for investment by the Local Government Pension Scheme are in need of reform, and the announcement made plain our expectation that authorities would be ambitious when developing their proposals. The publication of these criteria and their supporting guidance marks a significant milestone on the road to reform, placing authorities in a strong position to take the initiative and drive efficiencies in the Scheme, and ultimately deliver savings for local taxpayers.

The Scheme is currently organised through 89 separate local government administering authorities and a closed Environment Agency scheme, which each manage and invest their assets largely independently. Recognising the potential for greater efficiency in this system, the coalition government first began to consider the opportunity for collaboration in 2013 with a call for evidence. Since then, we have been exploring the opportunities to improve; gathering evidence, testing proposals, and listening to the views of administering authorities and the fund management industry.

The Chancellor's announcement draws on this earlier work and in particular the consultation, *Opportunities for collaboration, cost savings and efficiencies,* published in May 2014 by the coalition government. More than 200 consultation responses and papers were received and analysed, leading to the development of a framework for reform that has administering authorities at its centre. The criteria published today make clear the Government's expectation for ambitious proposals for pooling, and invite authorities to lead the design and implementation of their own pools. The criteria have been shaped and informed by earlier consultations, as well as several conversations with administering authorities and the fund management industry which took place over the summer.

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. I know that many authorities have already started to consider who they will work with and how best to achieve the benefits of scale. These early discussions place those authorities on a strong footing to deliver against our criteria, and I look forward to seeing their proposals develop over the coming months.

Marcus Jones

Criteria

1.1 In the July Budget 2015, the Chancellor announced the Government's intention to work with Local Government Pension Scheme (the Scheme) administering authorities to ensure that they pool investments to significantly reduce costs while maintaining overall investment performance. Authorities are now invited to submit proposals for pooling which the Government will assess against the criteria in this document. The Chancellor has announced that the pools should take the form of up to six British Wealth Funds, each with assets of at least £25bn, which are able to invest in infrastructure and drive local growth.

1.2 The following criteria set out how administering authorities can deliver against the Government's expectations of pooling assets.

1.3 It will be for authorities to suggest how their pooling arrangements will be constituted and will operate. In developing proposals, they should have regard to each of the four criteria, which are designed to be read in conjunction with the supporting guidance that follows. Their submissions should describe:

A. Asset pool(s) that achieve the benefits of scale: The 90 administering authorities in England and Wales should collaborate to establish, and invest through asset pools, each with at least £25bn of Scheme assets. The proposals should describe these pools, explain how each administering authority's assets will be allocated among the pools, describe the scale benefits that these arrangements are expected to deliver and explain how those benefits will be realised, measured and reported. Authorities should explain:

- The size of their pool(s) once fully operational.
- In keeping with the supporting guidance, any assets they propose to hold outside the pool(s), and the rationale for doing so.
- The type of pool(s) they are participating in, including the legal structure if relevant.
- How the pool(s) will operate, the work to be carried out internally and services to be hired from outside.
- 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.

B. Strong governance and decision making: The proposed governance structure for the pools should:

i. 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;

ii. At the pool level, ensure that risk is adequately assessed and managed, investment implementation decisions are made with a long-term view, and a culture of continuous improvement is adopted.

Authorities should also revisit their internal processes to ensure efficient and effective decision making and risk management, while maintaining appropriate democratic accountability. Authorities should explain:

- The governance structure for their pool(s), including the accountability between the pool(s) and elected councillors, and how external scrutiny will be used.
- 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.
- Decision making procedures at all stages of investment, and the rationale underpinning this.
- The shared objectives for the pool(s), and any policies that are to be agreed between participants.
- 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.
- How any environmental, social and corporate governance policies will be handled by the pool(s).
- 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.
- How the net performance of each asset class will be reported publically by the pool, to encourage the sharing of data and best practice.
- 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.

C. **Reduced costs and excellent value for money:** In addition to the fees paid for investment, there are further hidden costs that are difficult to ascertain and so are rarely reported in most pension fund accounts. To identify savings, authorities are expected to take the lead in this area and report the costs they incur more transparently. Proposals should explain how the pool(s) will deliver substantial savings in investment fees, both in the near term and over the next 15 years, while at least maintaining overall investment performance.

Active fund management should only be used where it can be shown to deliver value for money, and authorities should report how fees and net performance in each listed asset class compare to a passive index. In addition authorities should consider setting targets for active managers which are focused on achieving risk-adjusted returns over an appropriate long term time period, rather than solely focusing on short term performance comparisons.

As part of their proposals, authorities should provide:

- A fully transparent assessment of investment costs and fees as at 31 March 2013.
- A fully transparent assessment of current investment costs and fees, prepared on the same basis as 2013 for comparison.
- A detailed estimate of savings over the next 15 years.

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

D. An improved capacity to invest in infrastructure: Only a very small proportion of Local Government Pension Scheme assets are currently invested in infrastructure; pooling of assets may facilitate greater investment in this area. Proposals should explain how infrastructure will feature in authorities' investment strategies and how the pooling arrangements can improve the capacity and capability to invest in this asset class. Authorities should explain:

- The proportion of their fund currently allocated to infrastructure, both directly and through funds, or "fund of funds".
- 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.
- 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.

Addressing the criteria

Requirements and Timetable

2.1 Authorities are asked to submit their initial proposals to the Government to LGPSReform@communities.gsi.gov.uk by 19 February 2016. Submissions should include a commitment to pooling and a description of their progress towards formalising their arrangements with other authorities. Authorities can choose whether to make individual or joint submissions, or both, at this first stage.

2.2 Refined and completed submissions are expected by 15 July 2016, which fully address the criteria in this document, and provide any further information that would be helpful in evaluating the proposals. At this second stage, the submissions should comprise:

- 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
- for each authority, an individual return detailing the authority's commitment to, and expectations of, the pool(s). This should include their profile of costs 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.

Assessing the proposals against criteria

2.3 The Government will continue to engage with authorities as they develop their proposals for pooling assets over the coming months. The initial submissions will be evaluated against the criteria, with feedback provided to highlight areas that may fall outside of the criteria, or where additional evidence may be required.

2.4 Once submitted, the Government will assess the final proposals against the criteria. A brief report will be provided in response, setting out the extent to which the criteria have been met and highlighting any aspects of the guidance that the Government believes have not been adequately addressed. In the first instance, the Government will work with authorities who do not develop sufficiently ambitious proposals to help them deliver a more cost effective approach to investment that draws on the benefits of scale. Where this is not possible, the Government will consider how else it can drive value for money for taxpayers, including through the use of the "backstop" legislation, should this be in place following the outcome of the consultation described below.

Transitional arrangements

2.5 Plans should be made to transfer assets to the pools as soon as practicable. Analysis commissioned by the Government from PricewaterhouseCoopers (PwC) indicates that, even those pooling mechanisms requiring supporting infrastructure, such as collective investment vehicles, could be established within 18 months. It is expected that liquid assets are transferred into the pools over a relatively short timeframe, beginning from April 2018. It is recognised that illiquid assets are likely to transition over a longer period of time. For the avoidance of doubt, investments with high penalty costs for early exit should not be wound up early on account of the pooling arrangements, but should be transferred across as soon as practicable, taking into account value for money considerations. Any assets that are held outside of the pool should be kept under review to ensure that arrangement continues to provide value for money.

2.6 While authorities will need to be mindful of their developing pooled approach, they should continue to manage both their investment strategies and manager appointments as they do now until the new arrangements are in place. In keeping with the investment regulations, they are still responsible for keeping both under regular review.

Support to develop proposals

2.7 To help authorities develop proposals quickly and efficiently, the Government has made available PwC's detailed technical analysis of the different collective investment vehicles and their tax arrangements at: https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance. This paper is provided for information only. It does not represent the view of Government, and authorities should seek professional advice as needed when developing their proposals. Authorities are also strongly encouraged to learn from those who have already begun to develop collective investment vehicles, such as the London Boroughs or Lancashire and the London Pension Fund Authority.

Legislative context

2.8 At the July Budget 2015, the Chancellor also announced the Government's intention to consult on "backstop" legislation that would require those administering authorities who do not come forward with sufficiently ambitious proposals to pool their assets with others. That consultation has now been published and is available on the Government's website at: https://www.gov.uk/government/consultations/revoking-and-replacing-the-local-government-pension-scheme.

2.9 The consultation proposes to introduce a power for the Secretary of State to intervene in the investment function of an administering authority where it has not had sufficient regard to guidance published by the Secretary of State. The intervention should be proportionate and subject to both consultation and review.

2.10 The draft regulations include a provision for the Secretary of State to issue guidance. Subject to the outcome of the consultation, authorities would then need to have regard to that guidance when producing their investment strategy. The Government proposes to issue this document as Secretary of State's guidance if the draft regulations come into effect. The guidance will be kept under review and may be updated, for example if the proposals for pooling that come forward are not sufficiently ambitious.

2.11 The consultation also proposes to replace and update the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 to make significant investment through pooled vehicles possible.

Supporting guidance

3.1 This guidance is to assist authorities in the design of ambitious proposals for pooling investments and to provide ongoing support as they seek to ensure value for money in the long term. It will be kept under review to ensure that it continues to represent best practice.

A. Asset pool(s) that achieve the benefits of scale

Headline criterion: The 90 administering authorities in England and Wales should collaborate to establish, and invest through asset pools, each with at least £25bn of Scheme assets. The proposals should describe these pools, explain how each administering authority's assets will be allocated among the pools, describe the scale benefits that these arrangements are expected to deliver and explain how those benefits will be realised, measured and reported.

3.2 The consultation, *Opportunities for collaboration, cost savings and efficiencies*, set out strong evidence that demonstrated how using collective investment vehicles and pooling investments can deliver substantial savings for the Local Government Pension Scheme without affecting investment performance. Additional advantages to pooling, which should further reduce costs and improve decision making in the long term, include:

- Increasing the range of asset classes to be invested in directly,
- Strengthening the governance arrangements and in-house expertise available to authorities,
- Improving transparency and long-term stewardship, and
- Facilitating better dissemination of best practice and performance data between authorities.

The case for collective investment

3.3 Published in May 2014, the analysis in the Hymans Robertson report evidenced that using collective investment vehicles could deliver savings. In the case of illiquid assets alone, they found that £240m a year could be saved if investments were channelled through a Scheme wide collective investment vehicle rather than the existing "fund of funds" approach.[1]

3.4 A review of the academic analysis available also supports the case for larger investment pools. For example, Dyck and Pomorski's paper, *Is Bigger Better? Size and performance in pension fund management*, established that larger pension funds were able to operate at lower cost than their smaller counterparts, through a combination of

[1] Hymans Robertson report: *Local Government Pension Scheme structure analysis,* p.3 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/307926/Hymans_Robertson_report.pdf

improved negotiating power, greater use of in-house management, and more cost effective access to alternative assets like infrastructure.[2]

> A third to a half of the benefits of size come through cost savings realized by larger plans, primarily via internal management. Up to two thirds of the economies come from substantial gains in both gross and net returns on alternatives.

3.5 A number of respondents to the May 2014 consultation also set out the case for larger funds being able to access lower cost investments. London Councils, for example, estimated that savings of £120m a year could be delivered if £24bn was invested through the London collective investment vehicle (CIV), as a result of reduced investment management fees, improved performance, and enhanced efficiency.

3.6 Formal mechanisms of pooling, such as collective investment vehicles, offer additional benefits to alternative arrangements such as procurement frameworks. For example, Hymans Robertson explained that larger asset pools would increase the opportunities for buy and sell transactions to be carried out within the Scheme, reducing the need to go to the market and so minimising transaction costs. Their analysis found that this could reduce transaction costs, which erode the value of assets invested, by £190m a year.[3]

3.7 Pooling investments will also create an opportunity to improve transparency and information sharing amongst authorities. By having a single entity responsible for negotiating with fund managers and reporting performance, authorities can see what they are paying and generating in returns and how it compares with other authorities. Similarly, Lancashire County Pension Fund and the London Pension Fund Authority, who are developing a pool for assets and liabilities, anticipate economies of scale driving improved performance. They have recently estimated that by pooling they can achieve enhanced investment outcomes of £20-£30m a year from their current levels.[4]

Achieving appropriate scale

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

3.9 A move to larger asset pools would also be in keeping with international experience. For example, in Ontario, smaller public sector pension funds are being required to come together to form pools of around $50bn Canadian (approximately £30bn at the time the proposal was made). Similarly, Australian pension funds have been consolidating in recent years, where a formal review in 2010 recommended that each MySuper pension fund be required to consider annually whether they have sufficient scale and membership to continue as a separate pension fund.[5]

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[2] Dyck and Pomorski, *Is bigger better? Size and Performance in Pension Plan Management*, pp.14-15
[3] Hymans Robertson report, pp.14-15
[4] Sir Merrick Cockell, writing in the *Pensions Expert* on 30 September 2015
[5] Government Response to the Review into the Governance, Efficiency, Structure and Operation of Australia's Superannuation System, Recommendation 1.6,

3.10 The May 2014 consultation sought views on the number of collective investment vehicles to be established. Respondents stressed the importance of balancing the need for scale with local input and practical governance arrangements. It was also argued that while larger asset pools would deliver greater savings, the potential difficulties of successfully investing large volumes of assets in a single asset class, particularly active strategies for listed assets, should also be taken into account. However, while individual managers may restrict the value of assets they are prepared to accept or are able to invest, the selection of a few managers for each asset class would help to mitigate this risk.

3.11 Having reflected on the views expressed in response to the consultation and the experience of pension funds internationally, the Government believes that in almost all cases, fewer, larger assets pools will create the conditions for lower costs and reduce the likelihood of activity being duplicated across the Scheme, for example by minimising pooled vehicle set-up and running costs. It therefore expects authorities to collaborate and invest through no more than six large asset pools, each with at least £25bn of Local Government Pension Scheme assets under management once fully operational.

3.12 However, the Government recognises that there may be a limited number of bespoke circumstances where an alternative arrangement may be more appropriate for a particular asset class or specific investment. As set out below, this may include pooling to invest in illiquid assets like infrastructure, direct holdings in property and locally targeted investments.

Investment in infrastructure and other illiquid or alternative assets

3.13 The Hymans Robertson report highlighted illiquid or alternative assets as an area for significant savings for the Scheme. They found that in 2012-2013, illiquid asset classes like private equity, hedge funds and infrastructure represented just 10% of investments made, but 40% of investment fees. They also demonstrated that changing the way these investments are made, moving away from "fund of funds" to a collective investment vehicle, could save £240m a year.[6]

3.14 The Government expects the pooling of assets to remove some of the obstacles to investing in these asset classes in a cost effective way. A separate criterion has been included on infrastructure, although similar benefits exist for other alternative or illiquid assets, such as private equity, venture capital, debt funds and new forms of alternative business finance. In light of this, authorities should consider how best to access these asset classes in a more cost-effective way. Regionally based pools, such as the London boroughs' collective investment vehicle, would allow authorities to make best use of existing relationships, while a single national pool for infrastructure or illiquid assets would deliver even greater scale and opportunity for efficiency.

3.15 A considerable shift in asset allocation would be needed to develop a pool of £25bn for investment in infrastructure and other illiquid or alternative assets, such as private equity or venture capital. The Government recognises that such a significant movement in

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http://strongersuper.treasury.gov.au/content/Content.aspx?doc=publications/government_response/recommendation_response_chapter_1.htm

[6] Hymans Robertson report, p.24

asset allocation is unlikely in the near term. As such, should authorities elect to develop a single asset pool for illiquid investments or infrastructure, the Government recognises that a value of assets under management less than £25bn might be appropriate.

Investments outside of the pools

3.16 The Government's presumption is that all investments should be made through the pool, but we recognise that there may be a limited number of existing investments that might be less suitable to pooled arrangements, such as local initiatives or products tailored to specific liabilities. Authorities may therefore wish to explore whether to retain a small proportion of their existing investments outside of the pool, where this can demonstrate clear value for money. Any exemptions should be minimal and must be set out in the pooling proposal, alongside a supporting rationale.

Property

3.17 As of the 31 March 2014, authorities reported that they were investing around 2.5% of their assets in directly held property, with a further 4.1% invested through property investment vehicles.[7] However, the amount invested varies considerably between authorities, with some targeting investment of around 10% of their assets in direct holdings, for example.

3.18 A number of consultation responses stressed the importance of retaining direct ownership of property outside of any pooled arrangement, a view echoed in our discussions with interested parties over the summer. Directly held property is used by some authorities to match a particular part of an authority's liabilities, or to generate regular income. If these assets were then pooled, while the authority would receive the benefits of the pooled properties, there is a risk that this would not match the liability or cash-flow requirements that had underpinned the decision to invest in a particular property.

3.19 In light of the arguments brought forward by authorities and the fund management industry, the Government is prepared to accept that some existing property assets might be more effectively managed directly and not through a pool at present. However, pools should be used if new allocations are made to property, taking advantage of the opportunity to share the costs associated with the identification and management of suitable investments.

3.20 Where authorities invest more than the reported Scheme average of 2.5% in property directly, they should make this clear in their pooling submission.

Addressing the criterion

3.21 When developing their proposals for pooling, authorities should set out:

- The size of their pool(s) once fully operational.
- In keeping with the supporting guidance, any assets they propose to hold outside the pool(s), and the rationale for doing so.

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[7] Scheme Advisory Board, Annual Report http://www.lgpsboard.org/index.php/investment-performance-2014

- The type of pool(s) they are participating in, including the legal structure if relevant.
- How the pool(s) will operate, the work to be carried out internally and services to be hired from outside.
- 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.

B. Strong governance and decision making

Headline criterion: The proposed governance structure for the pools should:

i. 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;

ii. At the pool level, ensure that risk is adequately assessed and managed, investment implementation decisions are made with a long-term view, and a culture of continuous improvement is adopted.

Authorities should also revisit their internal processes to ensure efficient and effective decision making and risk management, while maintaining appropriate democratic accountability.

3.22 A number of consultation responses stressed the importance of establishing strong governance arrangements for pools. Securing the right balance between local input and timely, effective decision making was viewed as essential, but also a significant challenge. The management and governance arrangements of each pool will inevitably be defined by the needs of those participating. However, there are some underlying principles that the Government believes should be incorporated.

Maintaining democratic accountability

3.23 The May 2014 consultation was underpinned by the principle that asset allocation should remain with the administering authorities. Consultation respondents were strongly in favour of retaining local asset allocation, noting that each fund has a unique set of participating employers, liabilities, membership and cash-flow profiles, which need to be addressed by an investment strategy tailored to those particular circumstances.

3.24 Respondents also highlighted the transparency and accountability benefits offered by local asset allocation. If councillors are responsible for setting the investment strategy, then local taxpayers, who in part fund the Scheme through employer contributions, have an opportunity to hold their decisions directly to account through local elections. As one consultation response explained:

> The accountability of Members of the employing authorities playing a part in deciding locally how the assets of the Pension Fund are allocated is important. Employer contributions are paid, in the main, by local council tax payers who in turn vote for their local councillors. Those councillors should have the autonomy to make decisions relating to the investment strategy of that Pension Fund.

3.25 The Government agrees that this democratic link is important to the effective running of the Scheme and should not be wholly removed by the pooling of investments. As set out below, determining the investment strategy and setting the strategic asset allocation should remain with individual authorities. 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. For example, this might take the form of a shareholding in the pool for the authority, which is exercised by a member of the pension committee.

Strategic asset allocation

3.26 Establishing the right investment strategy and strategic asset allocation is crucial to optimising performance. It is increasingly accepted that strategic asset allocation is one of the main drivers of investment returns, having far greater an impact than implementation decisions such as manager selection.

3.27 The majority of respondents to the May 2014 consultation supported local asset allocation, but discussions with interested parties over the summer have highlighted a lack of consensus as to what constitutes strategic asset allocation. Definitions have ranged from selecting high level asset classes such as the proportions in bonds, equities and property; to developing a detailed strategy setting out the extent and types of investments in each of the different equity or bond markets.

3.28 Informed by these discussions with fund managers and administering authorities, the Government believes that pension committees should continue to set the balance between investment in bonds and equities, recognising their authority's specific liability and cash-flow forecasts. Beyond this, it will be for each pool to determine which aspects of asset allocation are undertaken by the pool and which by the administering authority, having considered how best to structure decision making in order to deliver value for money. Authorities will need to consider the additional benefits of centralising decision making to better exploit synergies with other participating authorities' allocations and further drive economies of scale. When setting out their asset allocation authorities should be as transparent as possible, for example making clear the underlying asset class sought when using pooled funds.

Effective and timely decision making

3.29 Authorities should draw a distinction between locally setting the strategic asset allocation and centrally determining how that strategy is implemented. The Government expects that implementation of the investment strategy will be delegated to officers or the pool, in order to make the most of the benefits of scale and react efficiently to changing market conditions. As one consultation response suggested:

> We believe that high-level decisions about Fund objectives, strategy and allocation are best made by individual Funds considering their better knowledge of their liabilities, risk and return objectives and cash flow requirements. More detailed asset allocation decisions should however be centralised to achieve better economies of scale, and to allow more specialist management.

3.30 Authorities will need to revisit and review their decision-making processes as part of their move towards pools. For example, in order to maximise savings, manager selection will need to be undertaken at the pool level. Centralising manager selection would allow the pool to rationalise the number of managers used for a particular asset class. The resulting larger mandates should then allow the pool to negotiate lower investment fees. This approach would also give local councillors more time to dedicate to the fundamental issue of setting the overarching strategy.

3.31 A number of authorities have already delegated hiring and dismissing mangers to a sub-committee comprised predominantly of officers. This has allowed these authorities to react more quickly to changes in the market, taking advantage of opportunities as they arise. Similarly, delegating implementation decisions to the pool will allow the participating authorities to benefit not only from more streamlined decision making, but also from effecting those decisions at scale.

3.32 The creation of pools will necessarily lead to a review of decision making within each authority. The Government expects to see greater consolidation where possible. However, as a minimum, we would expect to see the selection of external fund managers and the implementation of the investment strategy to be carried out at the pooled level.

Responsible investment and effective stewardship

3.33 In June 2011, the Government invited Professor John Kay to conduct a review into UK equity markets and long-term decision making. The Kay Review considered how well equity markets were achieving their core purposes: to enhance the performance of UK companies and to enable savers to benefit from the activity of these businesses through returns to direct and indirect ownership of shares in UK companies. The review identified that short-termism is a problem in UK equity markets.[8]

3.34 Professor Kay recommended that Company directors, asset managers and asset holders adopt measures to promote both stewardship and long-term decision making. In particular, he stressed that 'asset managers can contribute more to the performance of British business (and in consequence to overall returns to their savers) through greater involvement with the companies in which they invest.'[9] He concludes that adopting such responsible investment practices will prove beneficial for investors and markets alike.

3.35 In practice, responsible investment could involve making investment decisions based on the long term, as well as playing an active role in corporate governance by exercising shareholder voting rights. Administering authorities will want to consider the findings of the Kay Review when developing their proposals, including what governance procedures and mechanisms would be needed to facilitate long term responsible investing and stewardship through a pool. The UK Stewardship Code, published by the Financial Reporting Council, also provides authorities with guidance on good practice in terms of monitoring, and engaging with, the companies in which they invest.

Enacting an environmental, social and corporate governance policy

3.36 The investment regulations currently require authorities to set out within the statement of investment principles the extent to which social, environmental or corporate governance considerations are taken into account in the selection, retention and realisation of investments. The draft regulations published alongside this document do not propose to amend this principle.

3.37 These policies should be developed in the context of the liability profile of the Scheme, and should enhance the authority's ability to manage down any funding deficit and ensure that pensions can be paid when due. Indeed, environmental, social and

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[8] *The Kay Review of UK Equity Markets and Long-Term Decision Making*, pp. 9-10 https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf

[9] The Kay Review, p.12

corporate governance policies provide a useful tool in managing financial risk, as they ensure that the wider risks associated with the viability of an investment are fully recognised.

3.38 As the Law Commission emphasised in its 2014 report on the fiduciary duty of financial intermediaries, the law generally is clear that schemes should consider any factors financially material to the performance of their investments, including social, environmental and corporate governance factors, and over the long-term, dependent on the time horizon over which their liabilities arise.

3.39 The Law Commission also clarified that, although schemes should make the pursuit of a financial return their predominant concern, they may take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.

3.40 The Government’s intention is to issue guidance to authorities to clarify that such considerations should not result in policies which pursue municipal boycotts, divestments and sanctions, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government. Investment policies should not be used to give effect to municipal foreign or munitions policies that run contrary to Government policy.

3.41 Authorities will need to determine how their individual investment policies will be reflected in the pool. They should also consider how pooling could facilitate implementation of their environmental, social and corporate governance policy, for example by sharing best practice, collaborating on social investments to reduce cost or diversify risk, or using their scale to improve capability in this area.

Addressing the criterion

3.42 When developing their proposals for pooling, authorities will need to set out:

- The governance structure for their pool(s), including the accountability between the pool(s) and elected councillors, and how external scrutiny will be used.
- 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.
- Decision making procedures at all stages of investment, and the rationale underpinning this.
- The shared objectives for the pool(s), and any policies that are to be agreed between participants.
- 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.
- How any ethical, social and corporate governance policies will be handled by the pool(s).
- 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.

- How the net performance of each asset class will be reported publically by the pool, to encourage the sharing of data and best practice.

- 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.

C. Reduced costs and excellent value for money

Headline criterion: In addition to the fees paid for investment, there are further hidden costs that are difficult to ascertain and so rarely reported in most pension fund accounts. To identify savings, authorities are expected to take the lead in this area and report the costs they incur more transparently. Proposals should explain how the pool(s) will deliver substantial savings in investment fees, both in the near term and over the next 15 years, while maintaining overall investment performance.

Active fund management should only be used where it can be shown to deliver value for money, and authorities should report how fees and net performance in each listed asset class compare to a passive index. In addition authorities should consider setting targets for active managers which are focused on achieving risk-adjusted returns over an appropriate long term time period, rather than solely focusing on short term performance comparisons.

3.43 As set out in the July Budget 2015 announcement, the Government wants to see authorities bring forward proposals to reform the way their pension scheme investments are made to deliver long-term savings for local taxpayers. Authorities are invited to consider how they might best deliver value for money, minimising fees while maximising overall investment returns.

Scope for savings

3.44 Pooling investments offers an opportunity to share knowledge and reduce external investment management fees, as the fund manager is able to treat the authorities as a single client. There is already a considerable body of evidence in the public domain to support authorities in developing their proposals for investment reform and this continues to grow with new initiatives emerging from local authorities:

- **Passive management:** Hymans Robertson showed that annual fee savings of £230m could be found by moving from active to passive management of listed assets like bonds and equities, without affecting the Scheme's overall return.[10]
- Their analysis suggested that since passive management typically results in fewer shares being traded, turnover costs, which are a drag on the performance achieved through active management, might be reduced by £190m a year.[11]
- **Collective investment:** Hymans Robertson also demonstrated that £240m a year could be saved by using a collective investment vehicle instead of "fund of funds" for illiquid assets like infrastructure, hedge funds and private equity.[12]
- Similarly, the London Pension Fund Authority has estimated that they have reduced their external manager fees by 75% by bringing equity investments in-house, and hope to expand this considerably as part of their collective investment vehicle with Lancashire County Pension Fund.[13]

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[10] Hymans Robertson report, p. 12
[11] Hymans Robertson report, pp. 14-15
[12] Hymans Robertson report, p. 3
[13] Chris Rule, LPFA Chief Investment Officer, reported in *Pension Expert* on 1 October 2015

- **Sharing services and procurement costs:** The National Procurement Framework has also helped authorities to address some of the other costs associated with investment, such as legal and custodian fees, reporting measurable savings of £16m so far.[14]

3.45 As Hymans Robertson's analysis shows, just tackling the use of "fund of funds" for illiquid assets like infrastructure could save around £240m a year, with clear opportunities to go further. It is in this context that the Government is encouraging authorities to bring forward their proposals for collaboration and cost savings. Although a particular savings target has not been set, the Government does expect authorities to be ambitious in their pursuit of economies of scale and value for money.

In-house management

3.46 Some authorities manage all or the majority of their assets internally and so can already show very low management costs. In these cases, a move to a collective investment vehicle with external fund managers is unlikely to deliver cost savings from investment fees alone. However, there are wider benefits of collaboration which authorities with in-house teams should consider when developing their proposals for pooling. A pool of internally managed assets could lead to further reductions in costs, for example by sharing staff, research and due diligence checks; it may improve access to staff with stronger expertise in particular asset classes; and could introduce greater resilience in staff recruitment, retention and succession planning. Alternatively, newly created pools might wish to work with existing in-house teams to build up expertise and take advantage of their lower running costs.

Active and passive management

3.47 The May 2014 consultation considered the use of active and passive management by the Local Government Pension Scheme. Active management attempts to select fund managers who actively choose a portfolio of assets in order to deliver a return against a specific investment target. In practice, this is often used to try and outperform a benchmark, for that class of assets over a specific period. In contrast, passive management tracks a market and aims to deliver a return in line with that market.

3.48 The consultation demonstrated that when considered in aggregate, the Scheme had been achieving a market return over the last ten years in each of the main equity markets. This suggested that collectively the Scheme could have delivered savings by using less costly passive management for listed assets like bonds and equities, without affecting overall performance. While the majority of consultation responses agreed that there was a role for passive management in a balanced portfolio, most also argued that authorities should retain the use of active management where they felt it would deliver higher net returns.

3.49 In response to that consultation, the Government has now invited authorities to bring forward proposals for pooling investments to deliver economies of scale. The extent to which passive management is used will remain a decision for each authority or pool,

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[14] National LGPS Frameworks website, http://www.nationallgpsframeworks.org/national-lgps-frameworks-win-lgc-investment-award

based on their investment strategy, ongoing performance and ability to negotiate lower fees with fund managers. However, in light of the evidence set out in the Hymans Robertson report and the May 2014 consultation, authorities are encouraged to keep their balance of active and passive management under review to ensure they are delivering value for money. For example, should their net returns compare poorly against the index in a particular asset class over the longer term, authorities should consider whether they are still securing value for money for taxpayers and Scheme members.

3.50 When determining how to measure performance, authorities are encouraged to consider setting targets for active managers that are focused on achieving risk-adjusted returns over an appropriate long term time period, rather than solely focusing on short term performance comparisons.

Improving the transparency of costs

3.51 In addition to the fees paid to asset managers, there are considerable hidden costs of investment that are difficult to identify and so often go unreported by investors. In the case of the Local Government Pension Scheme, Hymans Robertson showed that investment costs in 2012-13 were at least £790m a year, in contrast to the £409m reported by the authorities.[15] Even the £790m understated the total investment costs as it excluded performance fees on alternative assets such as private equity and hedge funds (it included performance fees on traditional assets) and turnover costs (investment performance figures include the impact of turnover costs).

3.52 To really drive savings within the Scheme, it is essential that these hidden costs are better understood and reported as transparently as possible. Although many of these costs are not paid out in cash, they do erode the value of the assets available for investment and so should also be scrutinised and the opportunities for savings explored.

3.53 The Chartered Institute of Public Finance and Accountancy (CIPFA) has already made some changes to their guidance, Accounting for Local Government Pension Scheme management costs 2014, to encourage authorities to explore these costs and report some through a note to the accounts. For example, these include performance fees and management fees on pools deducted at source. Authorities should have regard to this guidance and ensure that they are reporting costs as transparently as possible.

3.54 In addition, the Scheme Advisory Board is commissioning advice to help authorities more accurately assess their transparent and hidden investment costs. Once available, authorities should take full advantage of this analysis when developing their proposals.

Addressing the criterion

3.55 As set out above, there is a clear opportunity for authorities to collaborate to deliver hundreds of millions in savings in the medium term. Although there is no overall savings target for the Scheme, the Government expects authorities to take full advantage of the benefits of pooling to reduce costs while maintaining performance.

[15] Hymans Robertson report, pp.10-11

3.56 To support the delivery of savings authorities bringing forward proposals are asked to set out their current investment costs in detail, and demonstrate how these will be reduced over time and the savings forecast. Where possible, costs should be reported back to 2012-2013 so that any cost reductions already achieved as a result of procurement frameworks and early fee negotiations are transparently captured.

3.57 Authorities are encouraged to provide:

- A fully transparent assessment of investment costs and fees as at 31 March 2013.
- A fully transparent assessment of current investment costs and fees, prepared on the same basis as 2013 for comparison.
- A detailed estimate of savings over the next 15 years.
- 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.
- A proposal for reporting transparently against their forecast transition costs and savings, as well as how they will report fees and net performance.

D. An improved capacity and capability to invest in infrastructure

Headline criterion: Only a very small proportion of Local Government Pension Scheme assets are currently invested in infrastructure; pooling of assets may facilitate greater investment in this area. Proposals should explain how infrastructure will feature in authorities' investment strategies and how the pooling arrangements can improve the capacity and capability to invest in this asset class.

3.58 Investment in infrastructure is increasingly being seen as a suitable option for pension funds, particularly amongst larger organisations. This may in part be the result of the typically long term nature of these investments, which may offer a useful match to the long term liabilities held by pension funds.

International experience

3.59 Multiple large international pension funds are investing a significant proportion of their assets in infrastructure. A recent OECD report, which analysed a sample of global pension funds as at 2012, showed that some Canadian and Australian funds (with total assets of approximately £35-40bn in 2014 terms) were investing up to 10-15% in this asset class.[16] The report also noted that those funds with the largest infrastructure allocations were investing directly, and that such investment was the result of the build up of sector-specific knowledge, expertise and resources.[17] This experience might be demonstrated through an organisation's ability to manage large projects, as well as the associated risk.

3.60 Figures published by the Scheme Advisory Board for the 2013 Annual Report show that around £550m, or 0.3%, of the Scheme's total assets of £180bn was invested in infrastructure.[18] This falls some way behind other large pension funds that have elected to invest in this area, such as those noted above and the Ontario Teachers Pension Plan which invested 6.1% according to the same 2014 report.

Creating the opportunity

3.61 The Scheme's current structure, where assets are locked into 90 separate funds, reduces scale and makes significant direct infrastructure investment more difficult for administering authorities. As a result, authorities may determine that they are unable to invest in infrastructure, or may invest indirectly, through the "fund of funds" structure. Such arrangements are expensive, as the Hymans Robertson report demonstrated and this paper sets out in paragraph 3.13.

3.62 Developing larger investment pools of at least £25bn will make it easier to develop or acquire improved capacity and capability to invest in infrastructure. In so doing, it should be possible to reduce the costs associated with investment in this area. This is likely to be the case particularly if authorities pool their infrastructure investment nationally, where the

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[16] OECD, *Annual Survey of Large Pension Funds: report on pension funds' long-term investments*, p.32, available at: http://www.oecd.org/daf/fin/private-pensions/LargestPensionFunds2012Survey.pdf
[17] OECD report, p.14
[18] Scheme Advisory Board annual report http://www.lgpsboard.org/index.php/scheme-investments

resultant scale may allow them to buy-in or build-up in-house expertise in relevant areas, such as project and risk management.

3.63 In considering such investment, administering authorities might want to reflect on the wide range of assets that might be explored, such as railway, road or other transport facilities; utilities services like water and gas infrastructure; health, educational, court or prison facilities, and housing supply. Authorities should also examine the benefits of both:

- Greenfield infrastructure – projects involving the construction of brand new infrastructure, such as a new road or motorway junction to unlock a housing development, or the recent investment of £25m by the Greater Manchester Pension Fund to unlock new sites and build 240 houses; and
- Brownfield infrastructure – investing in pre-existing infrastructure projects, such as taking over the running of (or the construction of a new terminal building at) an airport.

3.64 As set out above, investment in infrastructure represents a viable investment for pension funds, offering long term returns to match their liabilities. Authorities will need to make their investments based on an assessment of risk, return and fit with investment strategy. However, the creation of large pools will make greater investment in infrastructure a more realistic prospect, opening up new opportunities to develop or buy-in the capacity and capability required.

3.65 In developing their proposals for pooling, authorities should take the opportunity to review their asset allocation decisions and consider how they can be more ambitious in their infrastructure investment. The Government believes that authorities can play a leading role in UK infrastructure and driving local growth, and encourages authorities to compare themselves against the example set by the leading global pension fund investors in their approach to allocating assets in this area.

Addressing the criterion

3.66 Authorities should identify their current allocation to infrastructure, and consider how the creation of up to six pools might facilitate greater investment in this area. When developing proposals, authorities should explain:

- The proportion of their fund currently allocated to infrastructure, both directly and through fund, or “fund of funds”.
- How they might develop or acquire the capability 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.
- 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.

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Appendix 2

Draft response

<u>Local Government Pension Scheme: Investment Reform Criteria and Guidance</u>

<u>Kent Superannuation Fund Response</u>

Thank you for the opportunity to respond to your November 2015 consultation paper.

The Committee welcomes the decision to retain at Fund level all current responsibilities except for investment manager appointments and the exception given to Direct Property from being included in the pool. As you set out in paragraph 1.1 the key issue is achieving good investment returns, not just paying lower investment fees.

The Kent Fund is working with a group of Central, Eastern and Southern counties and there are already good signs that the sharing of best practice between like-minded funds could have real benefits for investment returns.

In your future thinking we would like you to take account of the following issues:

- Criteria 1.1 – the references to "British Wealth Funds" completely ignore that all LGPS funds are in deficit and that the reductions in local government funding reduce active contributions and increase the proportion of deferred members and pensioners. Funding these current and future liabilities is the prime responsibility of the LGPS funds and will remain so.

- Criteria C – all the preliminary work suggests that the costs of these changes will exceed the savings for many years to come. The investment vehicles will require significant costs – investment adviser and legal, and then there will be very large transition costs.

- Criteria D – investment advice is that green field infrastructure investment is not a suitable investment for mature pension funds. We would invest more in infrastructure if there were more low risk investable opportunities in the UK.

- 2.5 & 3.16 – We support the need to let investments with high penalty costs to withdraw from to be left outside the pool. If we put equities, fixed income and diversified return / absolute return should account for 80-85% of total assets. These are areas where the maximum gains from pooling can be made. We agree that new private equity and infrastructure investments should be made via the pool.

- 3.17-3.20 – Kent has consistently had the best performing Property mandate in the LGPS and we have an allocation of 13% of the Fund – way above the figures you refer to. We welcome that we can maintain the existing mandate but we believe we should be able to add to it outside of the pool. Each individual property is unique and we want to continue the award winning relationship we have with DTZ investors.

- 3.23-3.25 – These funds exist to pay current and future pensions and the local democratic accountability is crucial.

- 3.46 – The Kent Fund has no in-house management and nor do the shire funds we are in discussion with. We are highly skeptical of the claims made by the 8 funds who do in-house management – there is no independent verification of their investment returns and with passive management available at virtually no cost the in-house management issue is really insignificant for LGPS as a whole.

James Scholes
Chairman Superannuation Fund Committee

By:	Chairman Superannuation Fund Committee Corporate Director of Finance and Procurement
To:	Superannuation Fund Committee – 5 February 2016
Subject:	**PENSION FUND CUSTODY SERVICES REVIEW**
Classification:	Unrestricted

Summary: To seek the Committee's approval to expand the Fund's Securities Lending Programme

FOR DECISION

Background

1. Securities Lending is an additional source of income on assets directly held by the Fund. Tax considerations and market making are two of the key drivers for the market for securities lending.

2. LGPS regulations restrict lending to 25% of a Fund's total assets and only permit lending to EEA (European Economic Association) borrowers. When the Kent Fund's programme was agreed with JP Morgan, its then custodian, lending US stocks was excluded. In the past few years UK intermediaries have started borrowing US stocks and these arrangements are allowed within the LGPS regulations. The Kent Fund could now lend its US stocks to the intermediaries but this change requires the Committee's approval.

3. In the financial year 2014-15 the Kent Fund earned £327k from its Securities Lending programme on the basis of JP Morgan charging a fee of 30% of the revenue received.

4. In 2015 when the Fund went out to tender for custodian services the Northern Trust Securities Lending Programme was evaluated and taken into account in the award of the Custodian contract.

5. The Kent Fund contracted with Northern Trust for custodian services from 2 November 2015 and agreed with the bank that initially they would implement the programme that had previously been operated on Kent's behalf by JP Morgan.

6. Northern Trust has quoted a fee of 28% of revenue received for the current programme. Should we decide to include US stocks Northern Trust have quoted a fee of 19%.

7. All of the other 20 LGPS clients of Northern Trust engaged in securities lending already include US securities in their programmes.

Current Programme Parameters

8. The Fund's current programme parameters with Northern Trust are as follows:

   i) Security Types Approved for Lending
      a. UK Equity and Fixed Income
      b. International (excluding US) Equity and Fixed Income

   ii) Borrowers Approved for Lending
      a. UK borrowers including European UK and UK intermediaries (UK AUKI) approved

   iii) Approved Collateral
      a. US and UK Government Securities
      b. Eurozone Government Securities
      c. No cash

Proposal

9. The proposal is to expand the current lending programme to include US stocks, taking advantage of Northern Trust's lower fees, and enhance the income from the programme.

Benefits - Income enhancement

10. Based on the Fund's current asset profile the gross revenue for non-US stocks is estimated to be £559k. Given the current fee split of 72:28 estimated net income is £402k.

11. If US stocks are included in the lending programme Northern Trust propose a fee split of 81:19. Gross revenue for US equities is estimated to be £762k, net £453k. Total estimated net revenue is £1,070k.

12. Inclusion of US stocks could therefore increase the Fund's revenue by £453k, i.e. more than 100%.

Risk

13. Northern Trust has an extensive indemnity in place covering operational, counterparty and collateral risk which applies to our current as well as to the proposed expanded programme.

14. There are no plans to change any other parameters and therefore the risk profile of the lending programme is not affected.

Recommendation

15. The Committee is recommended to agree to an expansion of the Fund's securities lending programme to include lending US stocks.

Sangeeta Surana
Senior Accountant
Treasury and Investments
03000 416738

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By:	Chairman Superannuation Fund Committee Corporate Director Finance and Procurement
To:	Superannuation Fund Committee – 5 February 2016
Subject:	**FUND EMPLOYER MATTERS**
Classification:	Unrestricted

Summary: To report on applications for admission to the Superannuation Fund, a termination and a contract extension.

FOR DECISION

INTRODUCTION

1. This report sets out information on applications from organisations to become admitted bodies within the Superannuation Fund. It also advises of a termination and a contract extension. The Committee's approval is sought to enter into these agreements.

CHURCHILL CONTRACT SERVICES LTD

2. The Williamson Trust is awarding a 3 year contract for cleaning services at High Halstow Primary School Academy from 3 May 2016.

3. This involves the transfer of 2 employees from the Williamson Trust to Churchill Contract Services Ltd.

4. To ensure the continuity of pension arrangements for these employees, Churchill Contract Services Ltd has made an application for admission to the Superannuation Fund.

5. The admission application has been made under Schedule 2 Part 3 1 (d) (i) of the Local Government Pension Scheme Regulations 2013, as amended, and under this regulation the admitted body is required to provide a form of bond or indemnity. The Fund Actuary has assessed the level of bond at £6,000 for the first year and set an employer's contribution rate of 21.1% for a closed agreement.

6. The completed questionnaire and supporting documents provided by Churchill Contract Services Ltd have been examined by Officers to ensure compliance with the Local Government Pension Scheme Regulations, and Legal Services have given a favourable opinion on the application.

SERCO ENVIRONMENTAL SERVICES LTD (Grounds Maintenance and Associated Works)

7. Canterbury City Council awarded a Grounds Maintenance contract to Serco Ltd in 1995 and the staff joined their broadly comparable pension scheme.

8. From 1 April 2013 Canterbury City Council has extended the original arrangement by the award of a new contract for a period of 4 years 9 months and proposes to novate the contract from Serco Ltd to Serco Environmental Services Ltd in the autumn of 2016.

9. This involves the transfer of 7 employees from Serco Ltd to Serco Environmental Services Ltd.

10. To ensure the continuity of pension arrangements for these employees, Serco Environmental Services Ltd has made an application for admission to the Superannuation Fund.

11. The admission application has been made under Schedule 2 Part 3 1 (d) (i) of the Local Government Pension Scheme Regulations 2013, as amended, and under this regulation the admitted body is required to provide a form of bond or indemnity. The Fund Actuary has assessed the level of bond at £28,000 for the first year and set an employer’s contribution rate of 22.8% for a closed agreement.

12. The completed questionnaire and supporting documents provided by Serco Environmental Services Ltd have been examined by Officers to ensure compliance with the Local Government Pension Scheme Regulations, and Legal Services have given a favourable opinion on the application.

SERCO ENVIRONMENTAL SERVICES LTD (Waste and Street Cleansing)

13. Canterbury City Council awarded a Waste and Street Cleansing contract to Serco Ltd in 1995 and the staff joined their broadly comparable pension scheme.

14. From 27 March 2014 Canterbury City Council has extended the original arrangement by the award of a new contract for a period of 7 years and proposes to novate the contract from Serco Ltd to Serco Environmental Services Ltd in the autumn of 2016.

15. This involves the transfer of 5 employees from Serco Ltd to Serco Environmental Services Ltd.

16. To ensure the continuity of pension arrangements for these employees, Serco Environmental Services Ltd has made an application for admission to the Superannuation Fund.

17. The admission application has been made under Schedule 2 Part 3 1 (d) (i) of the Local Government Pension Scheme Regulations 2013, as amended, and under this regulation the admitted body is required to provide a form of bond or indemnity. The Fund Actuary has assessed the level of bond at £12,000 for the first year and set an employer's contribution rate of 20.5% for a closed agreement.

18. The completed questionnaire and supporting documents provided by Serco Environmental Services Ltd have been examined by Officers to ensure compliance with the Local Government Pension Scheme Regulations, and Legal Services have given a favourable opinion on the application

PROJECT SALUS (re Youth Services)

19. At its meeting on 6 November 2015 the Committee agreed that an amended agreement could be entered into with Project Salus re Youth Services following a contract extension to March 2016.

20. It has since transpired that the contract will be extended until 31 August 2016 and this revised date will be reflected in the amended agreement.

ROCHESTER CARE HOME LTD (re Robert Bean Lodge)

21. At its meeting on 6 November 2015 the Committee agreed that a termination agreement may be entered into with Rochester Care Home Ltd (re Robert Bean Lodge), based on a cessation date of 30 June 2015.

22. It has since transpired that the actual cessation date was 11 May 2015.

23. The actuary report has now been received which shows a surplus of £41,000.

RECOMMENDATION

24. Members are asked to agree :

    (1) To the admission to the Kent County Council Superannuation Fund of Churchill Contract Services Ltd; and

    (2) To the admission to the Kent County Council Superannuation Fund of Serco Environmental Services Ltd (re Canterbury City Council Grounds Maintenance and Associated Works); and

    (3) To the admission to the Kent County Council Superannuation Fund of Serco Environmental Services Ltd (re Canterbury City Council Waste and Street Cleansing); and

(4) That an amended agreement may be entered into with Project Salus re Youth Services; and

(5) That an amended termination agreement may be entered into with Rochester Care Home Ltd (re Robert Bean Lodge); and

(6) That once legal agreements have been prepared for (1) to (5) above the Kent County Council seal can be affixed to the legal documents.

Steven Tagg
Treasury and Investments
03000 416747