Appendix B

HYMANS ROBERTSON

# Department for Communities and Local Government

## LGPS structure analysis

December 2013


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For and on behalf of Hymans Robertson LLP


PUBLIC SECTOR

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## LGPS structure analysis

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# Introduction

There is much that the LGPS currently does well and a substantial body of evidence that administering authorities have been good stewards of invested funds:

- The LGPS has procured investment management services at fee levels that compare favourably with those paid by larger international peers, particularly for investments in traditional asset classes – this is testimony to the cost saving ethos and effectiveness of local authority procurement practice; and
- A number of initiatives have already been established and further pilot projects are underway which aim to reduce costs; these include joint procurement frameworks, collective investment vehicles, shared services and voluntary Fund merger.

Nonetheless, in order to achieve further meaningful savings, everyone in the LGPS community will need to remain committed to pursuing further and more widespread improvements in investment efficiency through collaboration and reform.

The primary purpose of this research project is to quantify the potential for additional **cost savings** across the LGPS using the best objective evidence and data currently available and to assess how those cost savings might be **accessed most readily**.

The project deliverables include quantification of potential savings in investment management costs for a range of reform options. However, we were not asked to provide any recommendation on a preferred approach. The preferred approach will be a matter for government to determine after a full consultation.

We are indebted to the commercial organisations and local authorities who made significant contributions to this project by providing performance data, costings and other valuable information that has enabled us to complete this research. We have acknowledged their contributions at the end of this report. The willingness of those organisations to help and the general support we have received from the wider LGPS community during this important project are evidence of the commitment of all involved to make sure that future decisions are based on robust and objective analysis.

This paper is the work of three partner organisations, Hymans Robertson, CEM Benchmarking Inc. (a global firm specialising in the benchmarking of investment performance and costs) and Squire Sanders (UK) LLP (a global law firm with a leading public sector pensions practice). It is the hope of Hymans Robertson and its partners that this report will provide the solid evidence base that is required for a well-informed consultation on the means by which the LGPS can make further cost savings for a sustainable future.

Linda Selman John Wright

# Executive Summary and Key Findings

## Purpose of project

- The primary purpose of this research is to quantify the potential for **cost savings** across the LGPS using the best objective evidence and data currently available and to assess how those cost savings might be **accessed most readily**.

## Key findings

### Investment costs

- Total asset management costs across the LGPS in 2012 were estimated at **£790m** (c.**44bps of total assets**), of which £745m was investment management costs and £45m oversight costs
- On a consistent basis total asset management costs for an international peer group of large funds with same asset mix were estimated at **41bps**.
- The investment costs **exclude**:
  a. performance fees on alternative assets such as private equity, hedge funds, etc. (However, they do include performance fees paid on traditional assets); and
  b. **turnover costs** (investment performance figures include the impact of turnover costs)
- Overall fees paid to fund managers by the LGPS are slightly lower than those paid by large peers for similar mandates. There is evidence that LGPS funds have been successful in securing particularly low levels of fee on some asset classes.
- The greatest potential for cost savings would result from changes to implementation style (i.e. less use of active managers and less expensive means of investing in alternative asset classes).

### Investment performance

- There are some funds which have performed consistently well relative to their peers. However, for the LGPS taken in aggregate, equity performance **before fees** for most geographical regions has been no better than the index.
- This outcome is consistent with wider international evidence which suggests that any additional performance generated by active investment managers (relative to passively invested benchmark indices) is, on average, insufficient to overcome the additional costs of active management.

### Traditional asset classes – potential savings

- Greater use of **passive investment** (“trackers”) for listed equities and bonds could save **£230m (13bps)** per year without damaging investment performance in aggregate across the LGPS.
- Greater use of passive investment is also expected to reduce turnover costs. We estimate that the reduction in turnover cost in 2012-13 as a result of investing passively in listed equities would have been c.£190m.
- The turnover costs are a drag on the performance delivered by active management and their impact is included in the reported asset returns.
- The benefits of passive investment for listed securities are likely to be best accessed through one (or a very small number of) pooled arrangement(s). If this asset pool included both LGPS funds and other non-LGPS pooled investments, this would maximise future “crossing” benefits (matching buyers and sellers to reduce transaction costs). The most appropriate type of collective investment vehicle needs to be established as part of next steps.

- The one-off **transition cost** involved in moving existing LGPS assets into suitable passive investments is estimated to be circa £215m provided the transition is effected over a timescale designed to minimise costs. c.£47m of this is stamp duty.
- To help minimise the transition cost, it would be preferable to have the LGPS implementation carried out as a single co-ordinated exercise; that is what this cost estimate assumes.
- This may seem like a significant up-front cost but it is actually no more than the hidden additional turnover costs incurred in active management which will be saved by investing passively for just one year.
- No additional funding or up-front cash is required from government or from local authorities. Transition costs are met from the assets of the scheme and would be reflected in asset valuations (like other investment transaction and turnover costs).
- Even allowing for other implementation costs, the payback period is likely to be just over **one year** from date of the transition to passive arrangements.

### Alternative assets – potential savings

- LGPS funds invest in "**alternative assets**" (private equity, hedge funds, infrastructure) for good reasons (diversification and return). Currently it is difficult for individual funds to access these investments with an appropriate degree of diversification without using "Funds of Funds" approaches. These are expensive because they add additional layers of fees on underlying funds. By pooling assets for alternatives across the LGPS, funds would be able to substantially reduce the use of Funds of Funds.
- Less use of Funds of Funds for alternative assets and early elimination of high fee alternative assets could eventually save another £240m (13bps) **or more** per year. It is not possible to achieve this saving immediately since it will be necessary to:

  a. establish suitable LGPS wide investment vehicles; and

  b. allow existing investments to unwind year by year over the next decade to avoid early exit costs. Further savings might be possible at a later stage using in-house teams. This would require significant investment in specialist in-house resource but we believe this would be more than compensated by more effective implementation and additional fee savings.

### How to achieve these cost savings

- All of the above cost savings could be achieved with minimal legislative change (e.g. requiring changes to secondary legislation governing investment limits). If the government chooses to use compulsion to maximise the benefits, there would be additional legal issues to consider.
- While the cost savings identified could be achieved without significant structural reform, asset pooling would be necessary to achieve the full potential of these cost savings and to enable higher levels of participation without which cost savings would be eroded.

## Costs and benefits of structural reform

The three options for **structural reform** in the scope of this project were set out by DCLG:

- **Option 1: A single asset pool**

  Under this option the 89 administering authorities would remain but there would be a single collective investment fund for all assets. Decision making on asset allocation and contribution strategies would remain with the 89 administering authorities. They would also continue to be responsible for their own liabilities, employer liaison and member administration.

- **Option 2: 5 to 10 asset pools**

  This option is the same as 1 except that there would be 5 to 10 collective investment funds (groupings beyond the scope of this report). The 89 administering authorities would remain. Each would be responsible for decision making on asset allocation and contribution strategies and for its own liabilities, employer liaison and member administration.

- **Option 3: 5 to 10 merged funds**

  Under this option, the 89 separate LGPS funds would be replaced by 5-10 merged funds. Responsibility for assets, liabilities, deficit management, employer liaison and member administration would all transfer to the new organisations responsible for the 5 to 10 merged funds.

- These three options differ in terms of:

  a. local investment decision making (it is assumed that under options 1 and 2 local decisions on strategic asset allocation would be retained, but not investment manager choice or implementation style);

  b. cost savings (options 2 and 3 may not be optimal scale for cost savings from implementation of passive investment and asset pools for alternatives);

  c. implementation costs and timescale and payback period (option 3 is likely to cost most to implement and take longest); and

  d. legal issues (might be more complex for option 3, fund merger).

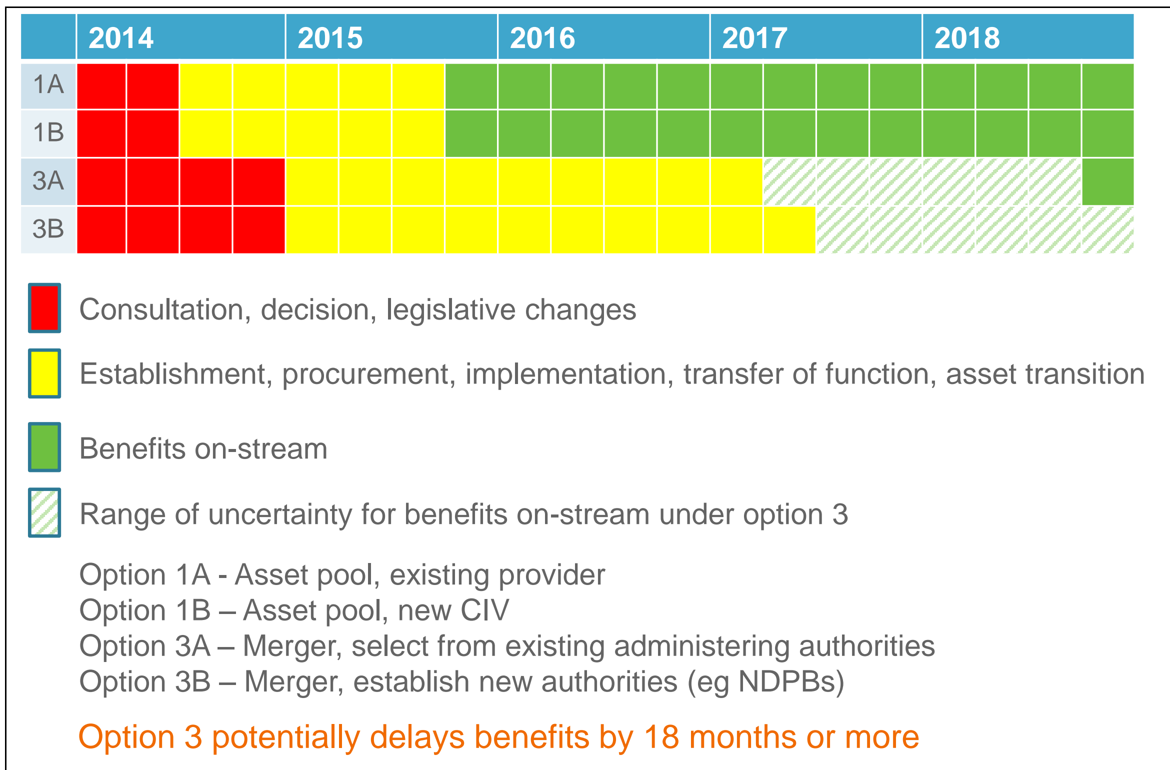
- Under Option 1, the net present value of savings is estimated to be circa £2.8bn over 10 years and £6.6bn over 20 years, based on:

  - Full participation
  - Using very large asset pools for passive investment
  - Using LGPS wide asset pool to reduce the Fund of Funds investment for alternatives

  These numbers take account of investment transition costs which will be paid out of the assets of the scheme. The numbers also take account of other operational costs of new arrangements, including set up costs for any collective investment vehicles and the associated ongoing monitoring and oversight arrangements.

- In addition the net present value of the savings over ten years from reduced transaction costs as a result of switching to passive investment in listed securities is £1.9bn. **Options 2 and 3** have similar benefits, slightly higher costs (although still modest relative to the cost savings) and longer payback periods. In the case of option 3, we have assumed it takes c.18 months longer to implement change. This delay reduces cost savings over 10 years by c.£0.7bn.

The picture below shows the implementation time-line for each of the options.




- The financial benefits quantified in the net present value measure in this report are most sensitive to the following factors, in descending order of significance:
    1. Participation/take-up;
    2. Extent of implementation – passive only or passive and alternatives;
    3. How early the changes are implemented;
    4. The level of fee savings on passive relative to current actual fees across the LGPS; and
    5. Scale of transition cost.
- The LGPS currently spends c£45m on investment oversight (this is twice the amount spent by large international peers). There might be modest additional cost savings in this area (e.g lower spend on advisers). Some of the savings could most appropriately be redeployed on internal resource for more widespread risk management including the greater amount of complexity resulting from the multi-employer nature of the LGPS (a feature not always present in the peer group).

A summary of the net present value of benefits is shown below.

| Option | Net present value of benefits over 10 years | Net present value (10yrs) of active management transaction costs | Comments |
|---|---|---|---|
| 1 | £2.8bn | £1.9bn | • Optimises benefits of pooling assets for passive and alternatives |
| 2 | £2.6bn | £1.9bn | • Sub-optimal size for investment scale benefits (e.g. crossing benefits on passive and diversification on alternatives) |
| 3 | £1.9bn | £1.4bn | • More complex legal issues to be resolved<br>• Could take significantly longer to implement, resulting in loss of cost savings<br>• Transfer of data and member administration from 89 funds to 5 or 10 makes implementation more onerous and more costly<br>• Combining member administration in this way may not be optimal approach<br>• Sub-optimal size for investment scale benefits<br>• Additional project implementation risk with little additional benefits |

**Other funded public sector schemes (stage 2)**

- In practice it is likely to be extremely difficult to apply any similar approach to cost saving across those schemes, if it involves compulsion on investment choice, since they are governed by private Trust Law and there are greater legal barriers to be overcome. Voluntary participation in any asset pooling may deliver some benefits. The implementation approach for any agreed changes should be designed to make this possible.

## Conclusions and summary

The investment fee savings we identify are £470m p.a. In the table below we identify the breakdown of these savings. We estimate that the reduction in turnover cost in 2012-13 as a result of investing passively in listed equities would have been c.£190m.

| Cost saving per annum | How | Timescale |
|---|---|---|
| £230m (12bps)* | More passive investment | Within two years |
| £240m (13bps)** | Lower cost alternatives | Full annual saving not achievable until Year 10 |
| £190m (11bps) | Lower turnover | Post transition |

* The cost saving equates to 15 bps of the value of listed securities, or 27bps of the actively managed listed securities

** The cost saving equates to 136 bps of the value of alternatives.

- There are a number of **conditions** for the delivery of the estimated benefits:
  - Legislative changes as required (e.g. secondary legislation on current investment limits).
  - Large (industry wide) asset pools to maximise scale benefits including crossing opportunities within passive arrangements.
  - Careful management of the transition to the new passive arrangement to minimise explicit costs and market impact costs (possibly a one-off LGPS wide exercise)
  - For Funds of Funds and alternatives, existing investments should be allowed to run their course to avoid incurring losses due to early redemption. All new investment would be made into new arrangements with lower implementation costs.
  - Full or widespread participation. Our estimates are based on full participation across the LGPS. It is a matter for government whether to use compulsion.
- The potential cost savings outlined above could be achieved with or without significant structural reform. However, asset pooling is necessary to deliver some of the potential cost savings fully (e.g crossing benefits in passive investment and more affordable access to alternatives) and may be helpful to enable high levels of participation without which the benefits could be lost.
- Next steps may include further consideration of legal aspects (especially if the government is considering compulsion) and practical details such as the most suitable and cost efficient types of vehicle for asset pooling (this may differ between passive investment and alternatives) and the mechanism by which the actual cost savings will emerge via employer contribution rates.
- These measures could **reduce LGPS investment costs by nearly a third** if the change to more passive investment is implemented and by **more than half once changes to alternatives work through.** Together the two changes could deliver savings of **£6.6bn over 20 years** if implemented effectively.

# Scope, principles, limitations

## Options in scope

In this report we consider three options for structural reform of the LGPS set out by DCLG.

**Option 1: A single asset pool**

Under this option the 89 administering authorities would remain but there would be a single collective investment fund for all assets. Decision making on asset allocation and contribution strategies would remain with the 89 administering authorities. They would also continue to be responsible for their own liabilities, employer liaison and member administration.

**Option 2: 5 to 10 asset pools**

This option is the same as 1 except that there would be 5 to 10 collective investment funds. The 89 administering authorities would remain. Each would be responsible for decision making on asset allocation and contribution strategies and for its own liabilities, employer liaison and member administration.

**Option 3: 5 to 10 merged funds**

Under this option, the 89 separate LGPS funds would be replaced by 5-10 merged funds. Responsibility for assets, liabilities, deficit management, employer liaison and member administration would all transfer to the new organisations responsible for the 5 to 10 merged funds.

## Objective

The primary objective of this exercise is to identify (and quantify using the best currently available data and evidence) the most significant potential cost savings and to assess how they might most readily be achieved under the three options. A different objective would require a different approach to the assessment and analysis of the options for structural reform.

Clearly all cost savings are measured relative to the status quo.

## Scope of report

The scope includes:

- quantification of current investment management costs (including investment management costs and turnover costs)
- identification (and quantification) of potential cost savings and the means by which they might most readily be achieved
- analysis of net of fees performance;
- estimation of cost of change (investment transition costs, cost of establishing new structures, future operational and oversight costs)
- cost benefit analysis of the three options; shape and timing of emergence of savings; payback period; annual cash savings and, since could be different under current actuarial practice, timing of high level implementation programme;
- emergence of benefits via contribution reductions; risks to benefits realisation; sensitivities on financials;
- practical and legal impediments to implementation (and benefits realisation); and
- high level assessment of the applicability of the options in scope to other (non-LGPS) funded public service schemes.

In benefits quantification, the focus is on “hard” data on cost reduction, rather than potential less easily quantifiable performance enhancements, including “governance premium”.

The following are NOT in scope:

- a recommendation on which option should be taken forward;
- dealing with deficits;
- member administration; and
- quantification of any governance dividend under different structure.

We have not considered how liabilities are managed; however, we have made the assumption that each employer will remain liable for the financing of their own liabilities, so the number of "employer liability pots" will be the same irrespective of the option chosen.

## Principles

In undertaking this project we have sought to adhere to the following principles:

- benefits quantification is evidence based, using the best data currently available;
- where there is no reliable, relevant evidence or data for benefits, this is not taken into account in the central scenario in the cost benefit analysis;
- our reporting is restricted to commentary and analysis based on data and evidence, not opinion (if there are any grey areas at the boundaries we distinguish between fact and opinion);
- we state any critical conditions for the delivery of any assumed benefits (e.g. the degree of participation);
- our analysis of legal barriers is based on our understanding of the law as it currently stands.

## Reliances and Limitations

Our report is addressed to our client for this project, the Department for Communities and Local Government (DCLG), for the sole purpose of assessing the cost and benefits of three options for structural reform of the LGPS (and other funded public sector pension schemes) as set out in the scope above along with practical and legal impediments to change. It has not been prepared for any other purpose.

This report must not be shared with any other party without our prior consent and if shared must be disclosed in its entirety. We do not accept any liability to any third party.

The information in this report is based upon our understanding of legislation and events as at 12 December 2013 and we have used all reasonable endeavours to ensure the accuracy or completeness of the information contained herein. DCLG acknowledge that we have relied on data and legal advice provided by our partner organisations in compiling this report, CEM and Squire Sanders, both under sub-contracting arrangements. Whilst reasonable efforts have been made to ensure the accuracy of the data and advice expressed, we cannot verify the accuracy of such advice and data and we cannot be held liable for any loss arising from use and/or reliance on such advice and data.

It should be noted that we do not provide legal services and therefore, we accept no liability to any third parties in respect of any legal opinions expressed in this report. Third parties are advised to take independent legal advice in respect of any legal matters arising out of this report.

A number of other organisations provided data to assist the project; for the avoidance of doubt, those organisations not party the client agreement with DCLG are not in any way liable for data they have provided.

# 1 Cost assessment

**Highlights**

- Based on data from a sample of 18 LGPS funds who volunteered their data, total asset management costs across the LGPS in 2012 were estimated by CEM Benchmarking Inc at £790m (c.44 bps of total assets)
- Of this £745m was investment costs and of that c.£710m was paid to active managers
- Moving equities and bonds fully passive would reduce fees by c.£230m p.a.
- The cost of transitioning equities and bonds to passive is estimated to be c £215m, of which £47million is stamp duty on purchases of UK equities
- The reduction in turnover cost in 2012-13 as a result of investing passively in listed equities would have been c. £190m.
- Alternatives are less than 10% of total assets but account for 40% of total fees
- Management costs for alternatives could be significantly reduced by reducing/removing the use of fund of funds though this would take time to achieve due to the long term nature of the underlying contracts.

### Total costs of managing the assets

In order to assess the total costs of the management of the assets of the LGPS and then identify where and to what degree savings can be made we have relied on analysis carried out by CEM Benchmarking Inc based on detailed information supplied voluntarily by 18 LGPS funds with total assets (as at 31 December 2012) of £38bn. This sample is representative of the LGPS by fund size; i.e. it represents small, medium and large funds in appropriate weightings. Table 1 below shows the breakdown by asset size.

The CEM analysis has identified the total costs and allocated them across asset classes down to a very detailed level and by implementation method (active vs passive, internal vs external, direct vs fund of funds). These realistic costs have then been applied to a fund size of £180bn with the actual asset allocation of the aggregate LGPS. Appendix 1A sets out the methodology applied by by CEM and provides more detailed results from their analysis.

**Table 1: Analysis of funds included in CEM investment cost benchmarking exercise**

| Fund size | All LGPS | Funds included |
|---|---|---|
| £5bn + | 29.9% | 23.6% |
| £2-5bn | 35.1% | 46.2% |
| £1-2bn | 20.9% | 19.4% |
| Less than £1bn | 14.0% | 10.7% |
| Total | 100% | 100% |
| Total Assets | £180bn | £38bn |
| Number of funds | 89 | 18 |

## Investment management costs

The CEM analysis at aggregate Scheme level extrapolates from the data provided by eighteen LGPS funds to estimate total investment management fee costs of £750m, equivalent to 41.5 bps of the assumed assets of £180bn. These costs include performance related fees on conventional assets but exclude performance-related fees on alternative assets. Turnover costs are also excluded.

Table 2 below breaks down these costs by asset class and by active and passive management.

**Table 2 – investment management costs by asset class**

| Asset class | % of total assets | Active fees (£000) | Passive fees (£000) | Total (£000) | % of total fees |
|---|---|---|---|---|---|
| Equities | 65.8 | 256,963 | 31,103 | 288,068 | 38.5 |
| Bonds and cash | 17.6 | 54,535 | 7,141 | 61,674 | 8.2 |
| Property | 6.8 | 97,996 | 0 | 97,996 | 13.1 |
| Alternatives | 9.8 | 300,883 | 268 | 301,151 | 40.2 |
| **Total** | **100.0** | **710,377** | 38,512 | **748,890** | **100.0** |

While this is a huge amount of money, the CEM analysis indicates that the LGPS as a whole is paying on average less than the peer group for active external investment management which makes up the bulk of the costs. The peer group would be paying £18m more than the LGPS for similar services. This reflects our experience that many funds have negotiated well with managers to bring their fees down. In particular, the data provided to CEM shows that LGPS funds are paying significantly less in fees paid for active management of their UK equities compared to that paid by the peer group; this may be at least partly influenced by the fact that the UK is the home market for LGPS funds. This differential is sufficient to reduce the total annual investment management fees paid by the LGPS by c. £50m. While there may still be scope to negotiate lower fees, the inevitable conclusion is that there is a limit to the benefit that can be secured by seeking further reductions in manager fees. It follows that, if costs are to be reduced significantly, other solutions have to be found.

The larger part of the fee burden suffered by the LGPS is for active management (£710m) which is significantly more expensive than a passive approach. Chart 1 (opposite) compares the allocation of LGPS fund assets with the fees paid to manage those assets. The chart highlights how cheap passive management of equities is and the disproportionate amount of the LGPS fee budget that arises from investment in alternatives. The management of active equities and bonds together account for £311m of fees. Alternatives account for less than 10% of the assets but for at least 40% of the fees (CEM's analysis does not capture performance-related fees on alternative assets).

**Chart 1: Total LGPS fund value and fee budget split by asset class**

## Reducing investment management costs

There are three key ways to reduce the costs of the investment management of the assets of the Scheme;

1. Reduce the level of active management in favour of passive – the fees for passive management are significantly lower than the fees for active management;
2. Reduce the layers of fees that are inherent in fund of funds arrangements which are common in the management of property and alternatives, and
3. Move more of the assets from external to internal management.

### Reducing active management in favour of passive

In aggregate, the LGPS uses less passive management than the peer group of large funds in the CEM analysis. (The use of passive management by the 18 LGPS funds combined is higher than that of the peer group of funds in the £25-£45 billion size group. However, the very large global funds make more extensive use of passive management than both LGPS funds in aggregate and global funds in the size range up to £45bn).

Realistically passive management is only available on listed assets, i.e. bonds and equities where there are market indices which can be replicated using either physical stock or derivatives or ETF's. Based on the analysis of the data submitted to CEM, we estimate that there is potential to save up to £230m p.a. if all of the equities and bonds are managed passively. Over 80% of these gains (c£193m) is attributable to equities. While there would be costs involved in transitioning from the current actively managed portfolios to passive which we quantify below, the savings are relatively easily accessible.

**Table 3: Estimated fees p.a.after moving all of equity and bond management to passive**

| | Fees (£000) | % of total fees |
|---|---|---|
| Equities (all passive) | 95,217 | 18.4 |
| Bonds (all passive) | 23,089 | 4.5 |
| Property (all active) | 97,996 | 18.9 |
| Alternatives (predominantly active) | 301,151 | 58.2 |
| Total | 517,453 | 100.0 |

We consider in Chapter 2 of this report the potential impact on performance, i.e. the returns that may be generated from an asset structure which is predominantly passive compared to one that is managed actively. We have included a more detailed analysis of the fee savings achievable for listed securities by moving from active management to passive in Appendix 1B.

### Reducing the layers of fees in fund of funds arrangements

The Scheme has more assets in fund of funds than the peer group. This is likely to be due to the relatively small size of the individual LGPS funds relative to the average size of the peer group. The fund of funds route has enabled the LGPS to diversify their exposure but comes with an additional layer of fees. We believe that there are significant savings to be achieved by accessing alternative assets more directly than the Scheme does at the moment. There is global research which identifies the reduced costs achieved by very large funds that invest directly into private equity in general and infrastructure in particular. CEM's analysis indicates that the higher use by the Scheme of fund of funds arrangements for investing in private equity relative to the global

peer group adds c. £14m to investment management costs; the peer group still has a significant level of fund of funds exposure so there could be even bigger gains to be made than this figure indicates.

However we believe that the costs involved in 'dismantling' the existing fund of fund structures are likely to be extremely onerous and that the sensible approach would be to allow existing closed end funds to run off, while ensuring that any commitment is conducted differently / directly. Lower costs will be easier to achieve if we can identify some means of consolidating the assets of the Scheme that are allocated to alternatives, e.g. into a single entity, to access investment opportunities as cheaply and effectively as possible. We return to this below.

**Moving assets from external to internal management**

External active management tends to be much more expensive than internal or passive management. The Scheme uses more external management than the peer group. CEM's analysis indicates that the impact on the costs of the Scheme of using more external management than the global peer group is of the order of £57m of which c.£21m are associated with alternative assets. Research carried out by CEM[1] showed that the fee for an active EAFE (essentially global ex North America) equity mandate managed externally was over four times as much as an internally managed mandate (46bps v 10 bps).

Six of the 89 LGPS funds in England and Wales already manage a significant portion of their assets internally and qualify for inclusion in State Street's peer group of internally managed UK pension funds. (To qualify for inclusion more than two thirds of assets must be invested by in-house fund management team.) We consider the relative performance of internally and externally managed funds in Chapter 2.

### Oversight, custodial and other costs

The CEM analysis indicates that if the experience of the 18 funds is extended to the whole Scheme, the LGPS is estimated to be spending c.£45m on oversight, custodial and other asset related costs. This includes consulting and performance measurement of c. £11.5m. CEM estimates that as a whole the LGPS is paying c £22m more than the peer group with c £9m of this being excess consulting and performance measurement costs. The balance of the excess cost is allocated to 'oversight'. Given that for the LGPS this represents the costs of 89 funds, each with similar oversight functions, against the cost of a single fund in the peer group there is an implication that reducing the number of entities required to oversee the investments could result in some savings and that this should be possible without compromising the quality of the oversight. (Alternatively the same expenditure might be applied in more effective ways through collaboration or structural change.) However the cost savings here are of second order magnitude compared to the potential savings in direct investment management costs.

**[1] 'The World's Lowest Cost Funds, Herbert Lum, Research Director, CEM Benchmarking Inc, Oct 2006**

**Table 4: comparison of Oversight, Custodial and Other Costs**

| Activity | LGPS (£000s) | Peer Group(£000s) | Cost/savings(£000s) |
|---|---|---|---|
| Oversight | 19,077 | 6,512 | 12,565 |
| Custodial/trustee | 9,881 | 9,881 | - |
| Consulting /performance measurement | 11,522 | 2,696 | 8,826 |
| Audit | 1,911 | 1,274 | 637 |
| Other | 2,542 | 2,839 | -297 |
| **Total** | **44,933** | **23,202** | **21,731** |

### Other costs of investment – turnover and transactions costs

All investment portfolios suffer transaction costs due to dealing in the underlying assets. Even a passively managed portfolio has some turnover due to changes in the constituents of the benchmark which will happen at regular intervals and the need to re-invest dividend income from the underlying holdings. The level of activity in an actively managed portfolio can be significantly higher and this has an adverse impact on costs. Not all transaction costs can be measured easily and accurately. There are explicit costs like broker commission and stamp duty which are measurable but other 'implicit' costs like the bid offer spread, market impact and opportunity cost are harder if not impossible to measure. Appendix 1C sets out more detail and definition of the components of transaction costs.

Table 5 below sets out the annual cost impact at the level of turnover of the market index for equities and the additional cost for incrementally higher levels of turnover.

**Table 5: Turnover and transaction costs (bps)**

| | | excess cost relative to passive | | | |
|---|---|---|---|---|---|
| Market | passive | 25% turnover | 50% turnover | 75% turnover | 100% turnover |
| UK | 0.08 | 0.20 | 0.45 | 0.70 | 0.95 |
| North America | 0.01 | 0.06 | 0.14 | 0.21 | 0.29 |
| Japan | 0.01 | 0.14 | 0.29 | 0.44 | 0.59 |
| Europe ex-UK | 0.03 | 0.09 | 0.21 | 0.32 | 0.43 |
| AP ex Japan | 0.04 | 0.15 | 0.33 | 0.51 | 0.69 |
| Emerging Markets | 0.10 | 0.20 | 0.48 | 0.76 | 1.04 |

According to State Street, the average internally managed fund turns over a quarter of its UK equity portfolio each year while the All Funds Universe average is 46% p.a. If we apply the turnover that State Street identified for the LGPS in the 2012-13 year across both UK and overseas equities and compare this to the cost of turnover if all of the equities had been managed passively, the extra cost identified is of the order of £190m p.a. This assumes that the turnover in non-UK equities is evenly spread across all regions and comes with the

caveat that the costs of turnover vary by region. Due to stamp duty of 0.5% on purchases the UK is an expensive market in which to trade, beaten only by emerging markets. It should be noted that this analysis does not capture all the elements of implicit costs e.g. market impact. We estimate that market impact could add a minimum of a further 5 bp of total equity assets turned over to costs, i.e. an additional £56m p.a.. Table 6 below sets out the composition of the £190m.

While there might be some debate about the actual transaction costs incurred by managers, it is worth noting that the transaction levels in 2012-13 were lower than the average for the five years to 2013. Based on the average turnover for the five years to 2013, the £190m would become £240m assuming the same transaction costs.

Another element of transaction costs is generated by mandate turnover as funds replace managers who have underperformed. However the impact of these transactions is included in the turnover identified by The WM Company and cannot easily be separated. The procurement activity associated with mandate turnover generates additional costs but these are small in relation to the other costs of change.

**Table 6 – estimated cost of turnover for LGPS equities**

| Market | One-way turnover % | Estimated. transaction costs (bid/offer plus fees) % | Excess cost of active manager turnover | Asset allocation at 1 Apr 2012 % | Extra cost on £180bn (£000s) |
|---|---|---|---|---|---|
| UK | 22.5 | 1.00 | 0.175 | 25.4 | 79,827 |
| North America | 34.5 | 0.30 | 0.092 | 10.8 | 17,881 |
| Japan | 34.5 | 0.60 | 0.199 | 3.4 | 12,202 |
| Europe ex-UK | 34.5 | 0.45 | 0.137 | 8.0 | 19,732 |
| Asia Pacific ex Japan | 34.5 | 0.72 | 0.215 | 3.6 | 13,908 |
| Emerging Markets | 34.5 | 1.12 | 0.308 | 5.2 | 28,871 |
| Global | 34.5 | | 0.150 | 6.0 | 16,200 |
| **Total** | | | | **62.4** | **188,621** |

Costs of turnover in government bonds will be significantly lower than in equities though the level of turnover is likely to be higher; State Street identify 45% one-way turnover in government bonds for the aggregate LGPS in 2012-13. Transaction costs in alternative assets are significant.

## Investment management costs under status quo and alternative structures

### Increasing the element of passive management

It would be possible to increase the proportion of the Scheme managed passively under either 'status quo' or any of the three alternative structures that this report considers.

The research we have done, as part of this project, on the passive management of equities leads us to the conclusion that there is a significant advantage to being an investor in a very large fund. The advantage comes from the reduction in frictional costs of trading either into or out of the passive pool of assets and from the regular rebalancing activity that is required. The managers of passive funds that we interviewed all described a process whereby flows of money either into or out of the passive fund benefit from a high degree of 'crossing'. Simply put, with a large number of investors with different behaviour patterns, at any dealing date there are likely to be both buyers and sellers. The first stage of deciding how to manage these transactions is to match

the buyers and sellers as far as is possible at the unit level (e.g. one investor selling UK equity fund units and another investor buying). The next stage is typically to use the residual cashflow to carry out any desirable rebalancing to improve the tracking of the assets in the fund. After that there may still be further opportunities for matching at the asset level with transactions that are taking place for other clients. However the larger part of the crossing is done at the unit level, perhaps because the 'shape' of the trades, buys and sells, is a good match. The managers we interviewed cited crossing between 20% and 60% of cash flows at unit level and relatively modest levels, c 10%, of crossing at asset level.

Under the status quo the bulk of LGPS assets that are managed passively are invested in pooled funds managed by the three largest passive managers and therefore arguably already benefit from the unit crossing of a large fund. As an example of scale, Legal and General's UK equity fund is £42bn and the resources applied to the management of the firm's passive business include c. 20 investment managers.

**Option 1 implications**

If the passive investment of the 89 funds was in a pooled fund or funds (if more than one manager were employed) dedicated to LGPS then there is likely to be a reduction in the crossing opportunities as all of the investors are likely to have cashflows going in the same direction as each other. While the UK equity assets would amount to almost £46bn, there would only be about £6bn invested in each of Japan and Pacific Basin ex Japan if the current asset allocation were maintained across the Scheme.

**Option 2 and 3 implications**

The same issues, i.e. reducing the opportunities for crossing units, apply as for option 1 although, with even fewer LGPS participating in each collective investment vehicle (CIV), the chance of crossing opportunities would be even lower. Under the 5 fund scenario would be c £36bn, resulting in less than £9bn of assets in the UK equity sub fund and around £1.25bn each in Japan and Asia Pacific Basin ex Japan.

Under each of these two options the issue of scale might be addressed by either;

- The CIV(s) holding units in one or more of the existing pooled funds rather than investing on a segregated basis, or
- Agreeing an arrangement with an existing passive manager to set up a sub-fund within an existing fund specifically for LGPS investments.

There are a number of reasons why we do not believe that internal management can compete with the current external managers of passive funds;

- The low fees that currently prevail for passive management
- The value of the crossing opportunities that are available when there are different investors in the pool with varying cashflow patterns
- The significant costs of resourcing the activity effectively (e.g. L&G have a team of c 20 managers allocated to managing passive mandates)
- The track record the existing managers have of adding value relative to benchmark.

### Reducing the layers of fees in fund of funds arrangements

The evidence globally is that it is only the very largest funds that invest directly into alternative assets using their own internal resources. This reflects the significant costs associated with the level of due diligence required to invest directly into private equity or infrastructure. Under options 2 and 3, even with only five CIVs, we do not believe that it would be practical to achieve adequate diversification for each £36bn fund through direct investment. We believe direct investment in alternative assets is only viable if the assets allocated are invested in a single and appropriately resourced collective vehicle.

### Moving more of the assets from external management to internal management

A study by CEM[2] showed that on average six front office investment staff were required for every US$10billion (£6bn) of assets managed internally. State Street[3] report that the internally managed LGPS funds employ teams that range in size from 8 to 22 with an average of 13. The largest of the internally managed LGPS funds is c. £10bn so LGPS staff numbers look quite large. State Street suggest that this may be because the LGPS funds are small relative to the funds in the CEM study (average US$90billion). However, our discussions with a number of the internally managed funds suggest that these figures probably include the 'back office' and accounting staff. CEM found that for every one front office investment member of staff there were 1.7 staff members engaged in governance, operations and support. Under the 5 fund model in options 2 and 3, this would imply 36 front office staff and 60 back office staff for each of the 5 asset pools or merged funds if all of the assets were managed internally. However these staffing requirements would be reduced if the listed assets were managed passively.

### Transition costs – increasing the element of passive management

While it is clear that, once in place, passive management of the equities and bonds would be cheaper than active management there are costs involved in the transition. In order to quantify these costs we designed a hypothetical transition. This involved moving all of the listed equities and bonds that are currently managed actively (apart from the small elements that are currently managed internally) to passive management.

The total costs of transition are estimated as c.£215 million. It should be noted that c.£47 million (22%) of the estimated transition cost is UK Stamp Duty on the purchase of UK equities involved in the reorganisation.

The cost estimate for transition assumes that implementation is carried out as a single co-ordinated exercise. The process and timescale for the transition is designed to minimise costs. The volume of trades involved will require multiple tranches of transitions to avoid high market impact costs.

Appendix 1D provides more information on transition methodology and the estimated costs.

**[2] 'How Large Pension Funds Organize Themselves', Jody MacIntosh and Tom Scheibelhut, Spring 2012**
**[3] Lessons from Internally Managed Funds, March 2013**

# 2 Performance impact of changes in asset management

**Highlights**

- While some funds have a good and consistent performance, there is no evidence that, in aggregate, the Scheme has outperformed regional equity markets over the ten years to 2012-13
- This is consistent with both UK and global evidence which suggests that any additional performance generated by active investment managers is on average insufficient to overcome the additional costs of active management
- There is evidence that internally managed pension funds in the UK have outperformed those with no internal management even before fees are taken into account
- However, global evidence suggests that the lower cost of internal management is the main reason for the outperformance of funds that have more internal management.

## Methodology

In this chapter we examine the potential for the changes in the management of the assets to impact on the investment performance. We have examined published research that provides evidence on UK and Global pension funds. For LGPS specific data we have used two sources of data;

1. Our proprietary database of LGPS fund performance which records for each fund, performance at total asset level for each the eight financial years from 2005-06 to 2012-13. This database has been built up over time by sourcing data from the published Annual Reports. It forms the basis for Table10 below.
2. Data supplied by State Street Investment Analytics detailing the returns by asset class at the aggregate Scheme level for each of the 10 years from 2003-05 to 2012-13. This information is summarised in Appendix 2a and forms the basis for Table 9 below.

## The LGPS investment model

The most common model for the management of the assets of an LGPS fund is a combination of active and passive management with external managers being hired to manage all of the assets. Those funds that have made allocations to alternatives, specifically hedge funds, private equity and infrastructure, have used a significant level of fund of funds structures. Some of the property exposure also incorporates funds of funds to get adequate diversification. A number of funds have some element of internal management (most commonly passive equities) but only six qualify for inclusion as internally managed under State Street's definition which requires over two thirds of the assets to be managed in-house.

There is a significant cost differential between active and passive management as we have shown in Chapter 1. Active management is selected on the assumption that the manager will outperform the benchmark by more than the additional cost of investment. The focus on what the extra cost is has been on the element that relates to manager fees. However, as we demonstrated in Chapter 1, there is an additional drag on active performance from the higher levels of turnover that active managers undertake. The impact of transaction costs is included but hidden in the reported performance. Although managers are required to make disclosures on the costs they incur, it is impossible to identify the full impact of trading costs.

## Comparison of performance of active v passive management

### UK evidence

State Street Investment Analytics published their most recent analysis of Active and Passive Management in July 2012. In the report, they 'consider the ranges of risks and returns for passively and actively managed equity portfolios of UK pension funds relative to broad market indices.'

Table 7 below shows the ten year returns by equity market for the passive and active equity portfolios of UK pension funds. The passive portfolios have, as expected, closely tracked the appropriate indices; the weighted averages for all regions are within 0.2% of the index return. The record of the actively managed portfolios shows a range from an outperformance in World Pacific ex Japan of 0.9% p.a. to an underperformance of 1.1% p.a. in North America.

The returns quoted do not take account of investment management fees.

**Table 7: Ten years to end 2011: Index and Weighted Average Returns (% p.a.) (Gross of fees)**

| Equity market | UK | North America | Europe ex UK | Japan | Developed Pacific ex Japan | World Pacific ex Japan |
|---|---|---|---|---|---|---|
| FTSE Index | 4.8 | 2.8 | 4.3 | 2.5 | 12.1 | 10.9 |
| Passive Portfolios | 4.8 | 2.6 | 4.3 | 2.6 | 12.2 | - |
| Active Portfolios | 4.9 | 1.7 | 4.5 | 2.0 | 11.8 | 11.8 |

### Global evidence

Research based on the asset allocations of US defined-benefit pension funds for the period 1990-2008 tested the role of three factors, market movements, asset allocation policy and active portfolio management, in explaining their returns. The results are reported in ‘Rehabilitating the Role of Active Management for Pension Funds’ by Michel Aglietta, Marie Briere, Sandra Rigot and Ombretta Signori. Table 6 below summarises their findings.

**Table 8: decomposition (%) of pension funds’ actual net returns 1990-2008 (Net of fees)**

| Factor | Global Allocation | Stocks | Fixed Income | Cash | Real Assets | Hedge Funds | Private Equity | TAA |
|---|---|---|---|---|---|---|---|---|
| Market* | 90 | 96 | 70 | 26 | 47 | 54 | 26 | 75 |
| Asset allocation | 4 | 2 | 3 | 13 | 2 | 2 | 2 | 5 |
| Active Management | 2 | 0 | 20 | 36 | 40 | 40 | 54 | 16 |
| Interaction effect | 4 | 2 | 7 | 25 | 11 | 4 | 18 | 4 |

*Market returns are defined as average returns of all pension funds

While the performance of traditional asset classes is driven mainly by market movements and active management makes little impact, active management plays a significant role for the alternative asset classes, particularly real assets, hedge funds and private equity. For equities, 96% of the return volatility is explained by market movements, 0% by active management and 2% by policy allocation. For real assets, market movements account for only 47% of performance while active management accounts for 40% highlighting the potential to add value through asset selection due to the heterogeneity of performance.

## LGPS evidence at aggregate Scheme level

**Data from State Street Investment Analytics (The WM Company)**

A number of LGPS funds have a good and consistent record of investment performance over long periods. However this is not replicated across the Scheme. In this section we consider the performance that has been achieved within equities (broken down into regions) and bonds. We do not consider the contribution from asset allocation.

We have examined the data for the aggregate LGPS (including Scotland and Northern Ireland) for the ten year period ending on 31 March 2013.

**Table 9: Ten years to 31 March 2013; Index and weighted average returns (% p.a.) (Gross of fees)**

| Equity market | UK | North America | Europe ex UK | Japan | Developed Pacific ex Japan | Emerging Markets |
|---|---|---|---|---|---|---|
| FTSE Index | 10.7 | 9.5 | 11.4 | 7.4 | 16.4 | 18.2 |
| Aggregate LGPS | 10.8 | 8.4 | 11.6 | 7.5 | 17.3 | 17.1 |
| Excess active return | 0.1 | -1.1 | 0.2 | 0.1 | 0.9 | -1.1 |
| Extra cost (p.a.) of active | 0.34* | 0.27 | 0.20 | n/a | 0.49 | 0.53 |

Sources: State Street Investment Analytics (The WM Company), CEM Benchmarking Inc.

*this is our estimate of the extra cost which reflects the low fees that the LGPS in aggregate pay for active management of UK equities. The global cost premium is estimated by CEM as 0.56%

Appendix 2A includes detailed analysis of performance across equities and bonds broken down into different time periods. Although some periods show stronger performance than others, there is no strong evidence that the aggregate Scheme has outperformed the market in the long term.

The funds' aggregate equity returns and the funds' regional equity returns are highly correlated with the broad market index. Correlation data provides an indication of the strength of the relationship between the funds' returns and the underlying index returns. It does not provide any information on the scale of the relative moves. For example, even the returns of a very active equity manager are likely to be highly correlated with the broad market index, typically in excess of 0.8. The correlations observed at aggregate Scheme level in equities are well in excess of 0.9 which reflects the high degree of overlap between the fund and the index holdings. Considering performance at the aggregate Scheme level masks the extent of the dispersion of returns across the funds.

**Analysis based of Hymans Robertson's data**

We have gathered the performance data for each of the LGPS funds at aggregate fund level over the eight years to 31 March 2013 and analysed it for each annual period and over the longer term. The difference here is that we are able to track the performance of each individual fund. Table 10 overleaf shows in tabular and graphical form the dispersion of returns over 1, 3, 5 and 8 years and for reference plots the returns for UK equities and UK government bonds over the same periods. Over 8 years the best performing fund has returned 5.5% p.a. more than the worst performing fund. Our analysis shows some evidence of funds with both consistently good and consistently poor performance.

In Appendix 2B we have included some further analysis by fund size. That analysis shows that there is no strong evidence that larger (>£1bn) LGPS funds have performed better than smaller funds (<£1bn) though there

is evidence that the performance is more widely dispersed for the smaller funds. This is counter to global research on the performance of large funds relative to small funds and may reflect the small sample size and the fact that even the largest LGPS fund is small in the global context.

**Table 10: Dispersion of returns for LGPS funds over 1, 3, 5 and 8 years to 2012-13**

| | 1 yr | 3yrs (p.a.) | 5yrs (p.a.) | 8yrs (p.a.) |
|---|---|---|---|---|
| Maximum | 17.9 | 11.3 | 10.1 | 10.5 |
| Upper quartile | 14.9 | 8.9 | 7.1 | 7.9 |
| **Median** | **13.9** | **8.3** | **6.4** | **7.4** |
| Lower quartile | 12.6 | 7.4 | 5.5 | 6.7 |
| Minimum | 10.0 | 6.0 | 3.3 | 5.0 |
| **UK equities** | **17.4** | **8.6** | **6.8** | **7.8** |
| **UK gov. bonds** | **5.2** | **8.3** | **7.2** | **6.4** |

## Comparison of internal versus external management

### UK evidence

State Street Investment Analytics monitor the performance of 21 funds that manage more than two-thirds of their assets internally using an in-house fund management team. The analysis was last performed on data as at end December 2011 when the funds were valued at £174bn. The average size of the internally managed funds was £8bn; four funds were valued at less than £1bn. Six of the funds that were included were LGPS funds and their total assets amounted to £17bn.

**Table 11: Performance of internally managed funds (%p.a.) to the end of 2011 (before fees)**

| | 5 yrs | 10yrs | 20yrs | 25yrs |
|---|---|---|---|---|
| Internal | 3.7 | 6.2 | 8.6 | 8.9 |
| All Funds | 3.5 | 5.9 | 8.3 | 8.6 |
| Relative | 0.2 | 0.3 | 0.3 | 0.3 |

As the cost savings from using internal management are significant, the differential performance after costs are taken into account will be even more substantial.

### Global evidence

Research by CEM[4] showed that funds with more internal management outperform funds with less at the total fund level. On average, funds earned 4.6 basis points more net value added for every incremental ten percent of internal management. The lower cost of internal management was the main reason for the differential.

Further research by CEM[5] examined the differential in performance between internal and external management at the asset class level. They found that before costs there was no statistically significant difference in gross value added performance between internal and external management at the asset class level. However, after costs were deducted internal management performed better than or equal to external management in all asset classes considered and there was a statistically significant difference in the performance of internally managed global non-US developed market equities (EAFE) of 96 basis points of net value added. Table 12 below summarises the results.

**Table 12: Higher (lower) value added for internally managed assets in bps**

| Asset class | Gross of costs | Net of costs |
|---|---|---|
| US Stock | (23) | 0 |
| EAFE Stock | 57 | 96 |
| Emerging Markets stock | (32) | 28 |
| Fixed Income | (15) | 0 |

The findings were consistent across country of domicile for the funds and across fund sizes in excess of $20billion and those less than $20billion.

### Internal management in the LGPS

We have identified five LGPS funds each of which would qualify to be included in the State Street Investment Analytics peer group of funds that are managed internally. Table 13 overleaf summarises their performance relative to the universe of LGPS funds over the eight years to 2012-13 and relative to their own benchmarks over ten years. While these funds have done well relative to their peer group they have not all managed to beat their benchmarks which provide a measure of what would have been achieved through passive management.

**[4] Internal Management Performed Better, Hubert Lum, December 2007**
**[5] Internal management does better after costs, Terrie Miller and Chris Flynn, October 2010**

**Table 13: LGPS Funds with internal management**

| Fund | Total assets as at 31 March 2013 £bn[1] | Performance % p.a. 8 years to 31 Mar 13[2] | Rank over 8 years[2] | 10 year Fund performance % p.a.[1] | 10 year Benchmark return % p.a.[1] |
|---|---|---|---|---|---|
| Derbyshire | 3.1 | 8.1 | 19 | 9.9 | 9.6 |
| East Riding | 3.1 | 7.9 | 29 | 10.1 | 10.2 |
| South Yorkshire | 5.3 | 8.3 | 12 | 9.9 | 9.9 |
| Teeside | 2.9 | 8.5 | 7 | 10.2 | 9.4 |
| West Yorkshire | 9.9 | 8.3 | 10 | 10.2 | n/a |

Sources: [1]Fund Annual Reports 2012-13, [2]Hymans Robertson database

As part of our research for this project we interviewed three out of these five funds to find out more about how their internal arrangements work and their investment philosophy. A key characteristic which is borne out by global evidence was low turnover at both stock and mandate level and indeed one cited the low turnover as having added 20-25bps to performance.

### Impact of reducing the use of fund of funds

Implementation using fund of funds results in high costs and this has an inevitable impact on performance. Research by CEM highlights that the fund of funds style of investing under-performed direct internal investing by 6.8% for private equity (1996-2012), by 5.5% for property (1995-2012).

**Table 14: Average value added (%) relative to customised investible benchmarks* by implementation style**

| Asset Class | Internal | Direct Limited Partnership | Fund of Funds |
|---|---|---|---|
| Private Equity | 6.2 | 1.8 | -0.6 |
| Real Estate | 0.7 | -1.1 | -4.8 |

* The investable benchmarks use a mix of public market equity and REIT indices that varies by region. The benchmarks are custom-lagged for each fund. The real estate benchmark is adjusted for the higher leverage of public indices.

The fees disclosed for these alternative asset classes are frequently understated. The three most common reasons are:

- Management fees are frequently reduced by revenue sharing (commonly called rebates)
- Carry (e.g. performance fees) is excluded
- For fund of funds, the costs of the underlying funds are excluded.

# 3 Financial analysis

**Highlights**

- Moving all of the equities and bonds to passive management will produce fee savings of c £230m p.a.
- Reducing the use of fund of funds and removing very high cost alternatives will produce further fee savings of c £240m p.a. though the full annual saving will not be achievable until year 10
- The cost of transitioning the equities and bonds to passive management is estimated at £215m
- These are the elements that have the biggest impact on the calculation of the net present value of the savings. The additional costs, e.g. establishing, operating and overseeing collective investment vehicles, are relatively insignificant, although we have taken them into account,
- The financial benefits are most sensitive to the following factors in descending order of importance
  - The participation or take-up rate (i.e. how many of the LGPS funds decide to invest through the pooled approaches)
  - The extent of the implementation of the changes – passive only or passive and alternatives
  - How early the changes can be made
  - The level of the savings on passive relative to current actual fees paid across the LGPS
  - The scale of the transition cost
- The net present value calculated over ten years varies by option; Option 1 £2.8bn, Option 2 £2.6bn and Option 3 £1.9bn

**Overview**

The financial analysis is based on two components, relating to the change of investment approach:

- The costs involved in undertaking the change; and
- The benefits arising over time from the changes which result in lower manager fees. In relation to benefits, the basis we have employed is to evaluate benefits in a relative sense, i.e. the difference between the new fees and the fees currently being paid by the LGPS in aggregate

The financial plan takes account of the incidence of both costs and benefits. Our analysis in Chapter 2 showed that there will be no meaningful impact on the returns generated under the new investment approach. Accordingly, we have made no allowance for either higher or lower investment returns.

Administration services are out of scope for this project. We have therefore excluded any assessment of potential future cost savings from re-organisation of administration services, under all three options.

**Costs**

The principal costs are:

- Establishment costs, e.g. the costs of specialist operating resource (personnel, support and infrastructure, including IT) for any new entities that are created. We have assumed a fixed cost of £500,000. It may be possible to use private sector partners in this area to contain costs.
- The cost of a dedicated investment management team for the collectivised alternative assets. We have made assumptions as to the initial size and quality of the investment team and allowed for this team to

grow in the years following establishment. An allowance has been made for the costs of office space, IT and other support services. This element of our assumptions was 'sense checked' against the actual experience of IFM Investors who have extensive experience of investing in alternative assets. IFM was established over 20 years ago and is owned by 30 major not for profit pension funds.

- Costs relating to the creation of collective vehicles. This will depend on the number of vehicles and their structure, e.g. different approaches might be required for listed securities and alternative assets. We have assumed a cost of £300,000 for a listed securities vehicle and £780,000 for an alternative assets vehicle.
- Contractual adjustment costs relating to procurement of new agents that are necessary and any penalty costs relating to the terminations of contracts of existing agents. Because notice periods are short (typically 3 months or less), we do not believe there to be any material termination costs.
- Project management, actuarial advice (for option 3) and legal costs.
- Transition costs relating to the direct and implicit costs involved in restructuring assets. This is the dominant cost element and essentially relates purely to the listed asset component. Much of the investment in alternative assets is held in closed-ended funds which would be expensive to exit early. Consequently, we have assumed that existing investments in closed-ended funds will be maintained and allowed to run off. However, we envisage that new investment in alternatives would adopt a different structural approach.

### Benefits

The principal benefits arise from:

- A switch from active to passive management for listed assets, which results in a significant saving in fees. We have used the data set out in Chapter 1 of this report.
- A gradual shift in the management of an element of alternative assets, from a fund of funds approach to a direct or funded approach. The benefit comes from the removal of an additional layer of fees, although the fact that the closed ended funds are allowed to run off means that the benefit comes through gradually. We have assumed the run-off takes place evenly over a 10 year period.
- The early closure of high fee contracts, where termination is straightforward (without penalty) and where the value of the product is of questionable value (in an aggregate LGPS context). This benefit amounts to c. £100 million p.a.; we have assumed that it will start to emerge 12 months after the decision to proceed is taken.

### Time period

Our approach enables us to model the incidence of costs and benefits quarter by quarter. We modelled the first 10 years and the next 10 years. We have used a discounted cash flow basis to calculate the net present value (NPV) of the aggregate saving (benefits less cost) over the first 10 years of the project.

A key assumption for the purpose of quantifying benefits is the implementation timeline, including assumptions as to when costs will be incurred and when benefits will start to emerge. More detail on implementation plans and timelines is given in Chapter 4. For consistency, net present value calculations for all options have been calculated as at 1 January 2015. We have assumed this is the date when the decision is taken regarding the option which is to be adopted.

For the purpose of financial modelling, central assumptions in the net present value calculation include the following:

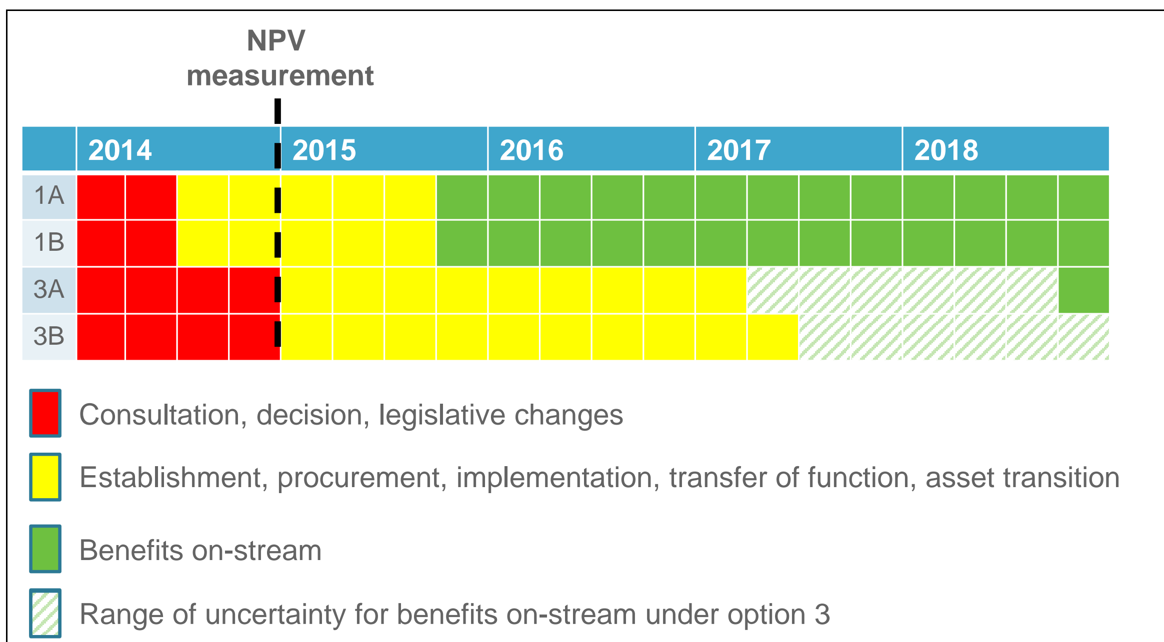
1) Under options 1 and 2, cost savings from the switch to passive investment come on-stream in Q4 2015;

2) Under option 3 (fund mergers), there is an 18 month time lag relative to options 1 and 2. Cost savings are assumed to start emerging in Q2 2017.

We expect the transition to new operational arrangements to take longer for option 3 (fund merger) because of the additional work and complexity involved in transferring membership data and records, member administration and liabilities, particularly if new administering authorities are established. There is also greater uncertainty in our timeline estimates for full fund merger due to greater uncertainty over legal impediments.

In practice the time lag could be greater than the assumed 18 months, in which case our estimate of the NPV of benefits under option 3 (over a 10 year period measured from 1 January 2015) could be an overstatement. On the other hand, even under option 3, the switch to investing passively (using asset pooling across the LGPS) could be implemented before fund merger, so the cost savings could emerge sooner.

The following graphic shows the incidence of various aspects of the project for structural change.




## Other financial assumptions

- Initial value of the assets - £180bn
- Asset growth rate – 6% p.a.
- Discount rate – 5.5% p.a.
- CPI assumption – 2.5% p.a.

## Risk to savings delivery

The principal risks to delivery of the savings will arise from:

- A take up of the new structure which is lower than modelled or in which the take-up comes through more slowly
- Time delay, i.e. if implementation is held up
- Greater transition costs than modelled.

### Sensitivity to assumptions

#### Participation/take-up

Assuming there is no compulsion, the assumption relating to the extent of participation in the new investment structure has a significant impact on the savings that can be anticipated.  We have tested the impact of 100%, 50% and 10% participation.  With lower participation, the cost of transition will reduce and this has been reflected in our modelling.  However the costs of creating collective vehicles and the establishment costs are unlikely to reduce.

While, as we have observed earlier in this report, the impact of turnover and transaction costs in active portfolios is already reflected in the reported performance numbers, we have indicated the incremental impact on savings of this element of cost for each level of participation.

#### Costs

The largest element is the transition cost, which for a full transition to passive management has been estimated to amount to £215 million.  This assumes that, after consolidating listed LGPS assets and identifying the portion to be traded, the transition is managed over a period of time rather than being achieved in a 'big bang' approach.  Approximately £47 million reflects UK stamp duty on the buy side of the UK equity transition.  We have tested the impact of the transition cost being 10% and 100% higher than estimated.  This latter figure represents something close to a 'big bang' approach.

We have indicated the sensitivity of the savings to the option adopted, allowing for the additional costs involved for options 2 and 3 of having five collective investment vehicles rather than one.  Additonally we have modelled a delay of 18 months in implementation for option 3 due to the additional legislation that is likely to be required.

#### Benefits

The major element relates to the fee reduction arising from the change from active to passive management on quoted equities and bonds which amounts to approximately £230 million p.a. in current cost terms.  A change in the approach to the management of alternatives results in the gradual emergence of savings of approximately to £1.1 billion over 10 years assuming 100% participation.

We have modelled our central assumption of £230 million p.a. savings and savings £30m higher and lower.  We have estimated figures for all 3 of the options.

### Observations

- The level of take-up will have a significant impact on the savings achieved
- The extent of the implementation, i.e. whether the alternatives are restructured as well as moving the traditional assets to passive, is likely to have the next most significant impact
- In contrast a variance in the cost of the transition to, or the fees paid for, passive management will have a more limited impact.

## Summary results - Comparative savings over 10 years

**Table 15: sensitivity to take-up/participation – option 1 assumed**

| Take-up | Savings in manager fees | | Manager fees and transaction costs |
|---|---|---|---|
| | Passive and alternatives £bn | Passive Only £bn | Passive only £bn |
| 100% | 2.8 | 1.7 | 3.6 |
| 50% | 1.4 | 0.8 | 1.8 |
| 10% | 0.2 | 0.2 | 0.3 |

**Table 16: sensitivity to DCLG options (1, 2 and 3) and transition costs – assumes 100% take-up**

| Transition cost assumption | Option 1 (one passive CIV, 1 alternatives CIV) £bn | Option 2 (5 passive and 5 alternatives CIVs) £bn | Option 3 (5 passive and 5 alternatives CIVs with 18 month delay in implementation) £bn |
|---|---|---|---|
| £215m | 2.8 | 2.6 | 2.0 |
| £240m | 2.8 | 2.6 | 2.0 |
| £400m | 2.6 | 2.4 | 1.8 |

**Table 17: sensitivity to DCLG option and level of passive fees – assumes 100% take-up**

| Assumption for savings from passive fees | Option 1 (one passive CIV, 1 alternatives CIV) £bn | Option 2 (5 passive and 5 alternatives CIVs) £bn | Option 3 (5 passive and 5 alternatives CIVs 18 month delay to implement) £bn |
|---|---|---|---|
| Central assumption - £230m across equities and bonds | 2.8 | 2.6 | 2.0 |
| Lower savings on passive - £200m | 2.5 | 2.2 | 1.7 |
| Extra savings on passive - £260m | 3.2 | 2.9 | 2.3 |

# 4 Implementation project plans

## Introduction

In this chapter we set out high-level implementation plans for establishing and managing a collective investment vehicle (options 1 and 2) and for fund merger (option 3). More detailed plans can be made available.

**Assumptions specific to establishing CIVs (options 1 and 2)**

- We have made some specific assumptions.
- DCLG is shown in the project plan in relation to the current project. We have assumed the involvement will relate to a preferred collective investment option. The period may be extended to allow for consultation. It is not clear to what extent activity will be conducted by other groups while the consultation proceeds.
- We have assumed there will be a "managing entity" which will direct activity around a collective vehicle. Because this will involve management activity over and above investment management, we have assumed that the managing entity will not be the direct "operator" of the collective investment vehicle, but will have a subsidiary company which will be the operator; this assumes that the managing entity will have "control" of the operator, rather than using a third party operator. The operator will need to be regulated by the FCA, which is the reason for setting it up as a subsidiary of the managing entity. Other activities conducted by the managing entity include:
  - Producing promotional and other material for potential CIV investors, i.e. LGPS funds
  - Reporting to and communicating with investors, both in relation to investment management activity, but also discussing aspects such as range of investment options, fee discussions, performance reporting
  - Monitoring the activity of the operator
  - Monitoring the activity of CIV providers (managers, custodian, etc.)
  - Assisting with resource, e.g. human resource function, IT, administrative personnel, offices accommodation, compliance, etc.
  - Assisting with procurement.
- We have assumed that a steering group will be established as a predecessor to the managing entity. This could be formed of a committee set up by a group of established administering authorities. The steering group would conduct preliminary investigations around the architecture of the collective vehicle. The managing entity is essentially a legal formation set up to continue the activity initiated by the steering group. The precise legal form of the managing entity is not defined – it might be formalised within an existing entity which collaborates across administering authorities.
- In order to establish the collective vehicle, both the operator and the vehicle itself will need (FCA) authorisation. The managing entity is likely to be a 'qualifying parent undertaking' under Part 12A of FSMA. The FCA has powers to oversee and give directions to the parent of an authorised person if that parent is not itself authorised.
- We have assumed that there will be a pilot transition of assets into the CIV, e.g. a single asset class transition could take place, as a live test of processes, prior to building out a wider group of sub-funds. This might not be consistent with a major transition to passive investment, which is likely to be more effective (in terms of speed and transition cost) if conducted in a single step.
- The actual project plan will depend on the specific architecture within the collective vehicle, so elements of the plan will change to accommodate specifics.

- We outlined implementation plans for two scenarios:
  - Under 1A we assume that an **existing provider** is procured – there may be savings in the establishment costs and timescale but any time saving may be offset by the required length of the procurement process;
  - Under 1B we assume that a **new vehicle and operator** are established as described above.

**Fund merger (option 3)**

- We considered two scenarios:
  - Under 3A, we assume that **existing administering authorities** are selected to run the 5 merged funds. This may reduce the time taken to establish and make operational the new arrangements. However, time must be allowed for a transparent and rigorous selection process.
  - Under 3B we assume that **new agencies** are established to run the merged funds. These may be some form of Non-Departmental Public Body (NDPB). It may take any new agencies longer to become operational since they will need to procure property, staff, systems and external services and establish and test their own operational procedures and controls before the process of transfer from existing administering authorities can commence.

For fund merger (3A and 3B) in addition to transferring assets, the implementation will include transfer of all functions associated with the running of an LGPS fund including member administration, employer liaison, in-house investment monitoring and management and governance arrangement. This is a complex exercise and is likely to take significantly longer to implement. We assume that this activity is over and above the structural changes that might be implemented on the investment management side since the 5 merged funds will need access to asset pools to achieve cost savings on investment management (the primary focus of this research).

**Key stages**

The table below sets out the main stages involved in each of the options. The detailed plans behind these stages can be made available.

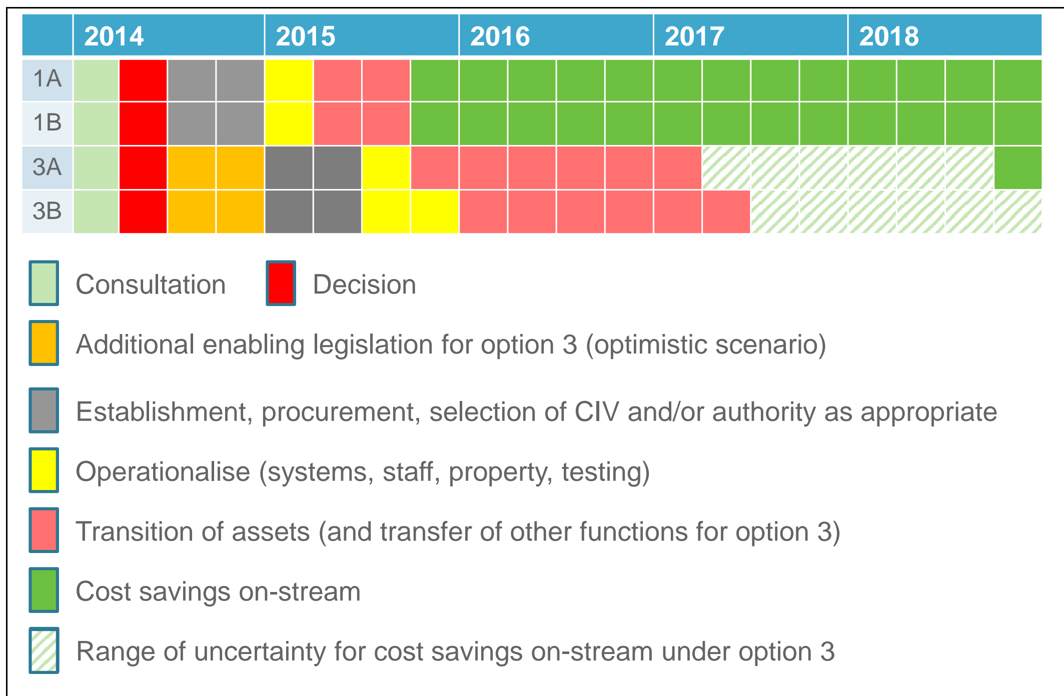
**Table 18: Key stages and elapsed time from January 2014**

| Option | 1A Asset pooling<br><br>Existing provider | 1B Asset pooling<br><br>New vehicle and operator | 3A Merger<br><br>5 existing authorities | 3B Merger<br><br>5 new authorities |
|---|---|---|---|---|
| 1) Consultation | 3m | 3m | 3m | 3m |
| 2) Assessment of consultation responses; government decision | 3m | 3m | 3m | 3m |
| 3) Legislation changes | N/A (c.6m but in parallel with 1) and 2) | N/A (c.6m but in parallel with 1) and 2) | 6-18m | 6-18m |
| 4) Specify requirements for new entities | N/A in parallel with legislation | N/A in parallel with legislation | N/A in parallel with legislation | N/A in parallel with legislation |
| 5) Establish new vehicle / authorities or select from existing | 6m (procurement) | 3m (select) | 6m (selection process) | 6-12m |
| 6) Operationalise (infrastructure, controls, procure IT for administration, staffing) | 3m | 6m | 3m | 6-12m |
| 7) Transition (assets) and transfer (liabilities and member admin) | 6m | 6m | 18-24m | 18-24m |
| 8) Benefits start to emerge | 21 months<br><br>(Q4 2015) | 21 months<br><br>(Q4 2015) | Between 39 and 57 months | Between 42 and 72 months |

**High level comparison of timelines**

The illustration below compares timelines for options 1A, 1B, 3A and 3B.

- Option 1A - Asset pool, existing provider
- Option 1B – Asset pool, new CIV
- Option 3A – Merger, select from existing administering authorities
- Option 3B – Merger, establish new authorities (eg NDPBs)




## Conclusions

Clearly asset pooling (options 1A and 1B) can be effected considerably more quickly. There is a greater degree of uncertainty over implementation timescales for fund merger (option 3) – possibly in the range 3 to 6 years from January 2014 - depending on the implementation approach and the time taken to resolve legal aspects.

For financial modelling of cost savings we have assumed there is a timelag relative to options 1 and 2 of at least 18 months before cost savings from option 3 (merger) come on-stream.

# 5 Practical impediments to change and mitigation

**Background**

The main impediments to change relate to:

1. The level of adoption for any new structure or change in investment approach designed to reduce costs, i.e. obtaining “buy in” or creating statutory powers to compel;
2. Difficulties around new implementations arising from Schedule1 limits within the current LGPS Investment Regulations;
3. Delays arising from any need for new entities to be established;
4. Delays or difficulties arising from funding and resourcing any new entities with required skills;
5. Project risk in relation to the restructure; and
6. Whether costs of the restructure will exceed benefits that can be achieved over a reasonable time frame or any lack of certainty over the potential scale of benefits.

Some of these impediments apply to each of the three options under consideration, for example, the current Schedule 1 limits (2 above). The impact of items 3 and 4 above may differ between one option and another.

**Practical impediments to change**

| Issue | Resolution |
|---|---|
| **Making the change**<br>There are risks and costs relating to the change in structure. | |
| • The opportunity for other means of cost saving is foregone while new entities and vehicles are being established | • Formal planning will minimise delays. Some other opportunities may continue |
| • The project may take longer than expected or may be implemented poorly | • Formal planning will minimise delays and risks of poor implementation |
| • Provider contract termination penalties may add to costs | • Notice periods are short, but a full assessment would be required |
| • Procuring providers will add delay and cost | • This will depend on the structure used and the parties procured |
| • Who will bear the costs of change? | • The charge will be against assets (see estimate) |
| • Transition will have an impact on markets | • Unlikely if well planned and phased |
| • Transition costs may be significant (or higher than envisaged) | • Should have large retained assets and low disruption.<br>• Significant existing security turnover will be suspended. The saving in normal turnover cost will offset transition cost.<br>• Existing investments in alternatives will be allowed to run off avoiding early termination costs. |

**Risks to realising benefits**

| Issue | Resolution |
|---|---|
| **Criticisms of proposed changes – stakeholder concerns** | |
| • Savings could be achieved without setting up CIVs. A feeling that any of options 1/2/3 are taking a sledgehammer to crack a nut. | |
| • A belief held by well-run funds and funds with good performance that the real problem to be addressed is poorly performing funds and good funds should be left alone | • If there is no compulsion, funds with good performance can opt out |
| • A perception or belief that option 3 will result in merging deficits and cross-subsidies between well-funded and poorly funded funds and employers. | • Easily avoided. Actuaries can continue to track individual employer/fund costs |
| • It is too difficult | • Switch to passive for listed assets is relatively straightforward |
| • Savings will be too small | • Report shows expected savings |
| • Significant shift to passive has impact on active managers | |
| • Significant shift to passive – scepticism about passive and belief that active management benefits are worth the extra cost | • Research indicates lack of certainty of returns from active management |
| • Change in asset allocation will disturb markets (and investee companies) | • No asset allocation shift planned |
| • Decision making will become more concentrated, thereby increasing risk | • Asset allocation decision making left with funds in options 1 and 2 |
| • Investment entities will become too large, creating capacity limits which will inhibit investment choice | • Move to passive essentially removes capacity constraints on listed assets. Scale will improve efficiency on alternative assets |
| • New entities may be inadequately resourced? | • Require adequate resourcing as a condition |
| • Will the new structure be future proof? | • Address in the plan |

**Details to be addressed**

| Issue |
|---|
| Who will bear the cost of change? |
| **Entities running collective vehicles and merged funds** |
| • Who will run the collective vehicles and merged funds? |
| • What procurement process is required for their selection as operators? |
| • How and by whom will collective vehicles and merged funds be governed and held accountable? |
| • What level of resource do new entities require? |
| • Existing administering authorities have tax-raising powers which, in extremis, might be used to finance pension obligations not met by participating employers. Under option 3, would the entities running merged funds have precepting powers or ability to levy? |
| **Collective vehicle investment choices** |
| • What investment choices would be available? |
| • Can new categories of asset be added? |
| • Will “hedging” categories (e.g. liability hedging) be included? |
| • What alternative asset options would be made available? |
| **Actuarial aspects** |
| • Impact of cost savings on employer contributions |

**Future proofing**

To what extent are the options future proof? The current project relates only to investment elements of structural reform. Can the result allow for:

- Future flexibility in funding and contribution management?
- Future flexibility in member and employer administration?

Option 3 has greater challenge in this area than options 1 and 2. The entity running a “merged fund” would need skills in investment, funding strategy (deficit management) and administration. These are essentially independent skill sets. The optimal future structure for administration, for example, may not be the same as that for investment pooling. Setting up an entity to manage all of three of these activities

- would be more complex;
- could add to establishment costs;
- could delay implementation and the emergence of cost savings.

# 6 Legal impediments to change and mitigation Squire Sanders

| Issue | Resolution |
| --- | --- |
| **Powers to enact change**<br>Options 1 and 2<br>Can funds be compelled to invest assets exclusively in collective investment vehicles which have been set up? | No power currently exists. Secondary legislation would be required to change the current investment powers of an administering authority |
| Option 3<br>Status of “power” to merge funds (assets and liabilities) | Would need specialist counsel opinion to determine if primary legislation can be avoided and to rebut challenge. |
| **Investment regulations**<br>Limits within existing legislation will inhibit the flexibility of pooled vehicles to provide the appropriate solutions | Re-draft the Investment Regulations (e.g. using a prudential risk framework) |

## Executive Summary: Legal Issues

### Options 1 and 2: Common Investment Vehicles: Issues and Interim Conclusions

1. The power of investment of an LGPS fund is vested in the administering authority, which also has a duty to invest monies it does not need to make payments from the fund. As such, since there is no power for another person, such as the Secretary of State, to exercise that function instead without regulatory intervention, administering authorities cannot be compelled to exercise their discretion to invest in a CIV (or any other instrument) without removing that function from them. On how such intervention might be made, however, see below generally under Option 3.

2. The Investment Regulations currently constrain LGPS funds’ investment powers by reference to some, but not all of the available structures and do so by reference to the legal form of the vehicle. Those Regulations expressly restrict investments in unit trusts, open-ended investment companies (OEIC) and life insurance unit linked funds when such vehicles are managed by the same body to impose maximum limits of 35% of fund assets at the time when an investment is made. Limited partnerships in aggregate (whether or not managed by the same body) are subject to an overall maximum limit of 30%, again measured at the time the investment is made.

3. Further limits apply by reference to other investments according to whether the investment is listed on a recognised stock exchange. Unlisted investments which are not caught by another limit under the Regulations are in aggregate limited to 15% of the fund, again at the time the investments are made.

4. The Regulations’ treatment of the financial services authorisation status of the expressly defined collective vehicles mentioned in 2 above is not the same. In order for an OEIC to benefit from the 35% limit, it must be a UCITS fund. This has implications for the investment powers of an OEIC, when compared to the alternative named vehicles, when used by an LGPS fund, as it would be constrained by the UCITS prudential rules in a way which need not apply to an unauthorised unit trust or limited partnership. A unit linked life fund is subject to separate prudential rules on the “permitted links” that the fund may hold, so again there are constraints as to what that vehicle may invest in.

5. While the unit trusts and limited partnership models have therefore an advantage in terms of investment freedom, they would, as with any other non-UCITS and non-life insurance funds, be subject to the Alternative Investment Fund Managers Directive, which imposes prudential rules on both the managers of such vehicles (and third parties involved in their operation) and the vehicle itself. Each model will have significant financial services implications in its establishment and operation.

6. The Regulations are silent on other legal forms of collective investment which are recognised under foreign jurisdictions. These include established overseas vehicles, which operate on a tax transparent basis, such as the Irish common contractual fund and the Luxembourg equivalent, fonds commun de placement. (Other Luxembourg law collective vehicles could be used.) The Regulations may limit investments in these other vehicles if they are incapable of being otherwise characterised as unit trusts, OEICs or limited partnerships, either to the unlisted securities limit of 15% and/or to a single holding limit of 10%.

7. The new UK equivalent to these Irish and Luxembourg tax transparent entities, the authorised contractual scheme (ACS) may be established on either a limited partnership or a tenants in common co-ownership basis. The ACS is not mentioned in the Investment Regulations, so the same consideration of how the limits apply to an ACS on the tenants in common model as in 6 above would apply; the alternative limited partnership structure is of course covered by the Investment Regulations.

8. Different regulatory capital and tax treatments apply to each of the above vehicles, so the cost of operation and the investment efficiency of each from an LGPS fund's perspective will differ according to which model is used. Similarly, there are recognised means of segregating liability under sub-funds for some but not all models.

**Collective Investment Vehicles: Key Differentiators**

| | Unauthorised UT | OEIC (UCITS) | LP | ACS | Life Fund |
|---|---|---|---|---|---|
| **Direct Ownership of Assets by investors** | no | no | yes | yes | no |
| **Capital Requirements for operator** | AIFM | UCITS | AIFM | AIFM | Life Directives (solvency II soon) |
| **Restrictions on Investments** | QIS limits (mainly real estate) | UCITS limits | QIS limits (mainly real estate) | QIS limits (mainly real estate) | Permitted links restrictions |
| **Tax Transparent** | no | no, but favourable tax regime | yes | yes | no but favourable tax regime |
| **Enhanced Insolvency Protection** | no | no | no | no | policyholders ahead of unsecured creditors |
| **Segregation of Sub-Funds** | no | yes | no | yes | no |

### Conclusions

The anomalies created between the different collective investment vehicles could be addressed under secondary legislation by removing the current limits and adopting a prudential framework as used in the private sector. This would need to be accompanied by governance changes to ensure that the new flexibility created by reform of the Investment Regulations was not abused.

**Option 3: Merged funds**

### Issues

9. A full merger of LGPS funds into however many new funds are deemed appropriate can only be achieved by confirming that the assets and liabilities of existing administering authorities can be transferred from their current control to other authorities or to new statutory bodies. In turn this leads to the following question: does the Secretary of State have the necessary powers to compel mergers of assets and liabilities? If not, primary legislation will be necessary to create such powers.

10. It is also necessary to look at other powers than those which govern the transfer of assets and liabilities. These include the degree of statutory prescription of functions which applies to current administering authorities and how scheme employers are mandated to adhere to a particular LGPS Funds.

11. The final consequential issue is whether third parties, whose rights and obligations are not expressly covered under the statutory framework, can also have their obligations and rights novated or assigned to apply to a new structure without individual contractual amendments.

### Interim conclusions

12. The Secretary of State does possess broad powers to make regulations under both the Superannuation Act 1972 (1972 Act) and the Public Service Pensions Act 2013 (2013 Act) in relation to the LGPS. The architecture of the legislation is complex. The LGPS is one scheme (in the sense of a tax approved entity as opposed to different benefit structures created over time) and, although governed by different legislation, administering authorities' funds are not hypothecated by reference to pre and post 2014 benefit structures. Where statutory powers differ under primary legislation, care must be taken about interpreting how they may be exercised to the scheme as a whole and to administering authorities' funds individually.

13. Our analysis of these powers confirms that while they are very similar in wording and effect in nearly all cases, particularly in relation to the way that administering authorities are mandated to have responsibility for their own funds and how scheme employers are attached to such funds, the wording used in relation to the power to "amalgamate" (ie merge) funds is different. Under the 1972 Act, there is an express power to amalgamate, but under the 2013 no such express power exists. It should be noted that the relevant powers relate to "funds", which are not defined in either piece of primary legislation, but we take the term generally to refer to assets, not liabilities.

14. Although the 1972 Act power to amalgamate funds has not been revoked, it may be inadvisable to rely on that power alone to merge funds (or liabilities) given that it has no reference to post April 2014 benefits.

15. For these reasons and given the risk of challenge without a clear statutory power on this issue, we recommend that an opinion is sought from leading Counsel as to the scope of the 2013 Act powers.

16. The 2013 Act does contain regulation making powers by which the Secretary of State may change the person who is responsible for providing benefits under the LGPS (ie the administering authority).

17. In relation to the final question under paragraph 11 above, there is no express power to novate or assign contracts between administering authorities and third parties (whether admission agreements or supply contracts for services). The 2013 Act does contain a power for the passing of consequential, supplementary, incidental or transitional provisions by regulations. Thus, if it can be established that an appropriate power does exist in the 2013 Act to merge assets and liabilities, it may be that that power could be used to effect such reorganisation of contractual arrangements.

18. There are some recent precedents for reorganisation of LGPS assets and liabilities, relating to the abolition of the GLC and metropolitan councils under the Local Government Act 1985 ie under primary legislation.

### Non-LGPS funds: application of Options

19. Since each of the schemes under consideration is governed by a separate trust deed and rules and not statute, like the LGPS, the investment and merger powers of those schemes are bespoke to each arrangement. Without further investigation as to the relevant trust powers, all that can be concluded is that there is no power to compel the trustees of these schemes either collectively or singly to invest in a CIV or to merge, either with each other or under a newly established scheme which might be established for LGPS funds.

# 7 Stage 2 funds

## Background

### Private sector – governance framework

In the private sector, the Trustee of an occupational pension scheme is a legally separate entity from that of its sponsoring employer or indeed any of the participating employers. The Trustee is the legal owner of the underlying assets but looks after those assets on behalf of the beneficiaries. The ability to pay beneficiaries' benefits, defined in a Trust Deed and Rules, depends on the resources of the scheme which are made up of the assets, the investment return on the assets and future contributions from the employer(s) and, if applicable, the members of the scheme. The employer's ability to continue making the contributions, i.e. its covenant, is therefore central to the security of the beneficiaries' benefits. The Trustee has a duty to collect the contributions, to invest the assets and contributions prudently and to help ensure that the correct benefits are paid to the right people at the right times. The trustee is therefore pivotal to the security of the benefits. Partly because of this, trustees are subject to much trust law (both pension and non-pension) and are heavily regulated. As a fall back, there is the Pension Protection Fund (PPF). However, the benefits payable from the PPF are typically lower than would be paid from the scheme.

Trustees in place for some time tend to build up a fairly strong pool of knowledge and skills. To help them, they appoint advisers. Trustees are required by law to appoint a scheme actuary, an auditor and investment manager(s). The funding must normally be agreed with the employer and the trustee has to consult with the employer on investment strategy. Ultimately, however, it is the trustees rather than the employer who have the final say.

### Public sector – governance framework

In the LGPS, the administering authority for a fund (which is usually also the main employer) is responsible and liable for the benefit payments. The benefits themselves are guaranteed under statute; that is the payment of benefits does not depend on the state of the assets of the scheme nor the contributions paid into it by the employer. As a consequence, the interest of the members in the LGPS lies largely in the arena of service delivery and communication, rather than security of assets. The administering authority may, and usually does, delegate pension activities under s101 of the Local Government Act 1972 to officers and committee(s). Best practice guidance mandates the formation of a pensions committee, called the section 101 committee. Unlike the Trustee situation, the section 101 committee is not legally separate from the administering authority. The running of an LGPS Fund is arguably therefore a "buffer fund" which assists in budgeting and contribution smoothing because of its impact on the administering authority's finances. Although never tested in the courts, there is widespread belief that, as a fall back, the Government would be the ultimate guarantor for the benefits. To date, LGPS Funds have not been as heavily regulated as their private sector counterparts but this is gradually changing as strengthened governance of LGPS Funds is sought. Funds have to appoint an actuary and an auditor but the reporting mechanism and nature of the actuarial advice differs from private sector scheme arrangements. The officers are very much the 'executive' arm of any committee(s) but invariably decisions are made by committee following officer recommendations. The high turnover among members of committees makes it difficult for the knowledge and skill level to build up. Whilst an actuary and an auditor have to be appointed, funding and investment are ultimately the responsibility of the administering authority.

Changes expected to be made through current governance reforms are likely to reduce some of the differences between the running of a private sector fund and its LGPS counterpart.

## Other funded public sector schemes

The spreadsheet of schemes identified by DCLG as falling to be considered in Stage 2 is included as Appendix 6A. We have traced information on 23 out of the 65 funds listed. A summary of our findings of the broad asset allocations for these funds is included in Table 19 below.

**Table 19: Asset allocation of some other funded public sector schemes**

| Pension Fund | Equities % | Bonds % | Property % | Alternatives % | Value (£m) |
|---|---|---|---|---|---|
| BR (Railways Pension Scheme) | 57 | 33 | 9 | 2 | 18,226 |
| British Coal Staff Superannuation Scheme | 68 | 17 | 7 | 7 | 9,105 |
| Mineworkers Pension Scheme | 66 | 19 | 10 | 5 | 10,960 |
| The BT Pension Scheme | 23 | 46 | 11 | 20 | 38,783 |
| The Audit Commission Pension Scheme | 0 | 14 | 0 | 86 | 662 |
| Bank of England Pension Fund | 0 | 100 | 0 | 0 | 3,122 |
| The British Museum Company Ltd Ret Bens Plan | 8 | 15 | 15 | 62 | 10 |
| British Tourist Board Staff Pension Life Assurance Scheme | 41 | 27 | 9 | 23 | 197 |
| British Transport Police Railway Pension Scheme | 53 | 17 | 9 | 21 | 76 |
| British Waterways Pension Fund | 57 | 43 | 0 | 0 | 308 |
| Combined Nuclear Pension Plan (all sections) | 40 | 35 | 10 | 15 | 678 |
| Combined Nuclear Pension Plan (Closed section) | 70 | 30 | 0 | 0 | 72 |
| GPS Pension scheme (at 31/3/2012 before transferring to CNPP) in WEC/UAM/SLC | 38 | 34 | 9 | 19 | 539 |
| Nirex Pension Scheme (part of CNPP) | 50 | 50 | 0 | 0 | 26 |
| Environment Agency Active Fund | 78 | 19 | 3 | 0 | 2,122 |
| Environment Agency Closed Pension Fund | 0 | 100 | 0 | 0 | 167 |
| Financial Services Authority | 48 | 45 | 6 | 0 | 484 |
| Highlands and Islands Airports | 58 | 42 | 0 | 0 | 71 |
| Highlands and Islands Enterprise | 61 | 39 | 0 | 0 | 64 |
| Legal Services Commission No.4 Pension Scheme | 45 | 52 | 0 | 3 | 352 |
| OFCOM Staff Pension Scheme | 16 | 22 | 0 | 62 | 249 |
| PCPF | 69 | 21 | 10 | 0 | 493 |
| Student Loans | 40 | 30 | 10 | 20 | 57 |
| **WEIGHTED AVERAGE/TOTAL** | **41** | **38** | **9** | **12** | **86,824** |

## Feasibility of applying changes to these schemes

Since each of the schemes under consideration is governed by a separate trust deed and rules and not statute, like the LGPS, the investment and merger powers of those schemes are bespoke to each arrangement. Without further investigation as to the relevant trust powers, all that can be concluded is that there is no power to compel the trustees of the schemes either collectively or singly to invest in a CIV or to merge, either with each other or under a newly established scheme which might be established for LGPS funds.

# Acknowledgements

Hymans Robertson acknowledges the assistance they have received in the preparation of this report from the following:

| **Passive managers** | Blackrock, Legal & General, State Street Global Advisers |
|---|---|
| **Transition managers** | Legal & General, Nomura |
| **LGPS funds** | East Riding, Derbyshire, Lothian, West Yorkshire |
| **Data providers** | IFM Investors, Legal & General, State Street Investment Analytics (The WM Company)<br><br>All of the LGPS funds which contributed data to CEM Benchmarking Inc. |
| **Other** | Northern Trust, HM Treasury<br><br>All contributors to the Call for Evidence |

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# Appendix 1a Investment cost benchmarking CEM Benchmarking Inc.

### The CEM approach

The CEM investment benchmarking survey and methodology has been developed over 21 years in conjunction with leading global pension funds. CEM captures the entire cost of investing the assets[6], including internal costs, investment manager fees and the cost of oversight and governance. Note that pension administration costs are specifically excluded from the analysis.

CEM takes great care to capture data consistently and accurately:

- They discuss the data collection process with all potential participants before starting
- They have a standard on-line survey that includes guidance on categorising data and that immediately identifies unusual or outlying data
- They discuss data issues with funds at length

They use defaults (typically peer or universe averages) where a fund cannot provide robust data.

The main drivers of pension investment costs are:

- Economies of scale (funds with more assets have a scale advantage)
- Asset mix (e.g. private equity is much more expensive than public equity)
- Implementation style (e.g. active is more expensive than passive management
- What funds pay relative to peer funds for similar assets and activities

### CEM's Cost Benchmarking Methodology – gathering, collating and analysing the LGPS data

Detailed data was gathered from 18 LGPS funds (who volunteered their data) with combined assets of c£38bn. This Combined LGPS Fund Small is treated as a proxy for one of the five asset pools / merged funds under DCLG options 2 and 3. The combined costs for these funds were compared with a global peer group of 21 funds in the range £25bn to £45bn (median £35bn size, LGPS 6$^{th}$ in size). CEM calculated a Benchmark Cost for Combined LGPS Fund Small. The Benchmark Cost applies the median cost for each asset class from the peer comparators to the Combined LGPS Fund's actual asset mix. The effect is to neutralise the impact of asset mix differentials in the cost comparison. By comparing Combined LGPS Fund's costs with the Benchmark Cost it is possible to understand whether Combined LGPS Fund's costs are reasonable and to analyse why they compare the way they do.

As a proxy for a single asset pool, as included in DCLG option 1, the cost data for the 18 sample LGPS funds was used again but CEM superimposed the current actual asset mix for the whole of the LGPS to assets of £180bn. CEM recalculated a Benchmark Cost for this larger fund, Combine LGPS Fund Large in the same way. The 16 global peers for this comparison have assets in the range £67bn to £408bn (peer median size £101bn, LGPS 4$^{th}$ largest).

**[6] All investment costs are included with two exceptions: transaction costs(related to buying/selling securities) and performance fees for private market asset classes (e.g. Private Equity, Real estate, Hedge Funds, Infrastructure). These costs are excluded because of historical difficulties in obtaining comparable data from participating funds.**

## Cost results

### Combined LGPS Fund Small

Combined LGPS Fund Small's total investment costs were 57.5 bps (0.575% of total assets). This comprised direct investment management costs of 55.0 bps and oversight, custodial and other costs of 2.5bps.

The Benchmark Cost was 54.6 bps – so Combined LGPS Fund Large was 2.8 bps more expensive than the benchmark.

**Table 20: Explaining why Combined LGPS Fund Small's costs are 2.8bps higher than Benchmark Cost**

| | Excess Cost/(Savings) £000s | Excess cost/(Savings) bps |
|---|---|---|
| Higher cost implementation style | | |
| • Greater use of fund-of-funds | 7,751 | 2.1 |
| • Differences in the use of active management | (13,664) | (3.6) |
| • Higher use of external management | 22,177 | 5.9 |
| • Higher use of overlays | 513 | 0.1 |
| | 16,778 | 4.5 |
| Paying more than peers for similar assets/activities | | |
| • External investment management costs | (7,120) | (1.9) |
| • Internal investment management costs | (217) | (0.1) |
| • Oversight, custodial and other costs | 1,229 | 0.3 |
| | (6,107) | (1.6) |
| Total | 10,670 | 2.8 |

The 18 LGPS funds have higher costs because

- They use more fund of funds than the peer group
- They have less internal management and therefore use more external management than the peer group.

These higher costs are offset to some extent because the LGPS funds

- Have more assets managed passively than the peer group does
- Pay less than the peer group for external management.

### Combined LGPS Fund Large

Combined LGPS Fund Large's total investment costs were 44.0 bps (0.46% of total assets). This comprised direct investment management costs of 41.5 bps and oversight, custodial and other costs of 2.5bps.

The Benchmark Cost was 40.6 bps – so Combined LGPS Fund Large was 3.4 bps more expensive than the benchmark.

**Table 21: Explanation of why Combined LGPS Fund Large's costs are 3.4bps higher than Benchmark Cost**

| | Excess Cost/(Savings) £000s | Excess cost/(Savings) bps |
|---|---|---|
| Higher cost implementation style | | |
| • Greater use of fund-of-funds | 7,030 | 0.4 |
| • Differences in the use of active management | 9,840 | 0.5 |
| • Higher use of external management | 57,422 | 3.2 |
| • Lower use of overlays | (16,060) | (0.9) |
| | 58,233 | 3.2 |
| Paying more than peers for similar assets/activities | | |
| • External investment management costs | (18,210) | (1.0) |
| • Internal investment management costs | 183 | 0.0 |
| • Oversight, custodial and other costs | 21,731 | 1.2 |
| | 3,705 | 0.2 |
| Total | 61,937 | 3.4 |

When the Combined LGPS Fund Large is compared to the larger peer group most of the same characteristics are observed as for the Small Fund. The notable difference is in the use of passive management. The LGPS fund uses less passive management than the peer group; larger funds have a higher allocation to passive management than the smaller funds. Some global research suggests that this is because of the diseconomies of scale that the largest funds experience and which increase the risk of moving prices against themselves when transacting in quoted equities.

# Appendix 1b Detailed analysis of active to passive savings

| Asset Class | Holdings (£millions) | Actively managed (£millions) | Passively managed (£millions) | Current Fees (£000) | Passive fees (£000) | Savings |
|---|---|---|---|---|---|---|
| **Equities** | | | | | | |
| Asia Pacific | 13,343 | 7,032 | 6,311 | 31,196 | 13,210 | 17,986 |
| UK | 49,406 | 24,162 | 25,244 | 101,538 | 19,268 | 82,270 |
| Europe ex UK | 15,146 | 7,934 | 7,213 | 20,413 | 20,296 | 117 |
| US | 17,490 | 8,475 | 9,016 | 28,814 | 10,319 | 18,495 |
| Emerging Markets | 8,835 | 6,131 | 2,705 | 56,391 | 19,790 | 36,601 |
| Global | 13,704 | 12,802 | 902 | 49,716 | 12,334 | 37,382 |
| **Total equities** | **117,924** | **66,536** | **51,391** | **288,068** | **95,217** | **192,851** |
| **Bonds** | | | | | | |
| UK | 17,130 | 8,655 | 8,475 | 24,144 | 14,218 | 9,926 |
| Emerging Markets | 708 | 708 | 0 | 5,722 | 1,770 | 3,952 |
| Global | 5,783 | 5,783 | 0 | 25,835 | 4,800 | 21,035 |
| Index linked | 7,934 | 2,524 | 5,409 | 5,370 | 2,301 | 3,069 |
| **Total Bonds** | **31,555** | **17,670** | **13,884** | **61,071** | **23,089** | **37,982** |
| Property | 12,146 | 12,146 | 0 | 97,996 | 97,996 | - |
| Alternatives | 17,528 | 17,406 | 122 | 301,151 | 300,883 | 268 |
| Cash | | | | 603 | 603 | - |
| **Total** | **179,153** | **113,758** | **65,397** | **748,889** | **517,787** | **231,102** |

# Appendix 1c Components of transaction costs

### Explicit transaction costs

Some transaction costs are said to be explicit because they do not depend on the trade price and are usually documented separately from it. They include brokerage commissions, market fees, clearing and settlement costs, and taxes/stamp duties all of which are generally known in advance, before the execution of the trade.

### Commissions

Brokerage commissions are paid to intermediaries for executing trades. Although they differ from one intermediary to another, they are a fixed and visible component of transaction cost.

### Market fees

Market fees are paid to trading venues for executing trades on their platforms. They are usually bundled into brokerage commissions for investors. These fees vary; on average, higher volume markets have the lowest costs. In recent years, competitive pressure has led to a significant reduction in these explicit costs.

### Clearing and settlement costs

Clearing and settlement costs are related to the process whereby the ownership of securities is transferred. When the trading venue owns the clearing and settlement system, these costs, which are fixed and visible transaction cost component, are usually included in market fees. Like the latter, clearing and settlement costs differ from one trading venue to another.

### Taxes/stamp duties

Tax rates or specific stamp duties are known in advance ; for example purchases of UK equities attract stamp duty of 0.5% of the purchase price.

### Implicit transaction costs

Transaction costs are more than just brokerage commissions, market fees and taxes. The cost of a transaction depends on its size, the timing of the trade and the way in which it is handled. The impact of these factors is implicit in the trade price and cannot be known in advance. These implicit costs can be broken down into their components: spread, market impact and opportunity costs.

### Spread

The spread is the difference between the best offer price (i.e. the lowest price at which the securities can be bought) and the best bid price (i.e. the highest price at which the securities can be sold).

### Market impact

Market impact is the difference between the actual execution price for a transaction and the price that would have prevailed if the security had not been traded; in other words the amount by which the transaction moved the price.

### Opportunity costs

The decision to trade and the actual trade do not usually take place at the same time. Market prices can move for or against the proposed trade. The opportunity cost is the loss (or gain) incurred as a result of the delay in completion of a transaction following the decision to trade.

# Appendix 1d Transition test methodology

## Background

In order to consider cost of transition for the LGPS, we asked two transition managers to estimate cost of change. The managers are experienced in the transitioning of LGPS assets and are aware of the portfolio distributions of institutional managers of UK mandates. Part of the instructions provided to the transition managers was to err on the side of prudence, which in this case means aiming to avoid an underestimate of the cost.

The transition was limited to listed securities, i.e. UK and global equities, which accounts for over 80% of aggregate LGPS assets. It is not feasible to transition property or alternative assets, e.g. private equity or other assets in closed funds.

## The transition model

### The legacy portfolio

Listed assets comprise 83% of aggregate LGPS assets, and are currently managed as follows:

- Approximately 23.5% of these assets are currently managed passively
- Approximately 12.5% of assets are currently managed internally, i.e. the securities are held in dedicated portfolios managed by personnel in the administering authorities
- The balance (47% of assets) are currently managed by external active managers.

### The target portfolios

We asked the transition managers to consider the following transition scenario:

- The existing passively managed assets and internally managed assets would remain in place.
- All externally managed assets (c£84bn) would transition to passive management.

#### Asset allocation

We used the data as at 30 September 2013 from The WM Company as the basis for the asset allocation of "legacy" assets. In relation to the shape of the target portfolio we made the following assumptions:

- The shape of the allocation to equities (i.e. the proportions held in the UK and regional overseas equity markets remained unaltered.
- In relation to bonds, WM data showed a modest allocation to overseas index-linked bonds which we transferred to UK index-linked gilts and a modest allocation to pooled bonds which we transferred to UK fixed interest (a composite of gilts and corporate bonds).

## Transition approaches

The transition managers' approaches follow three stages:

1) Comparing the legacy and target portfolios, in order to determine overlap of securities (both by security name and the number held). These holdings will transfer in kind between the legacy and target portfolio and will bear no costs (other than custody costs of re-denomination)
2) Internal crosses within the transition management operation (e.g. with other clients). This includes dual listed shares, e.g. the legacy portfolio may hold US-listed depositary receipts which are essentially the US-listed clone of a security listed on another exchange.
3) Externally traded securities with execution normally conducted via programme trades and through brokered deals. Transition managers make extensive use of this type of dealing so broking commissions are set at

the lowest commodity level. Trades are executed efficiently to minimise market impact, i.e. avoiding the size of dealing affecting the dealing price. Clearly exchange costs and duties are unavoidable.

## Provisos

- The cost estimate assumes that implementation of the transition is carried out as a single co-ordinated exercise.
- The process and timescale for the transition is designed to minimise costs; the volume of trades involved will require multiple tranches of transitions to avoid high market impact costs.

## Analysis of test transition

### UK equities

UK equities form the largest equity category. The transition manager made assumptions about the shape of portfolios of active UK equity managers (based on their knowledge of managers' portfolios from transitions they conduct and our breakdown of the largest managers of UK equity mandates for the LGPS and the proportions of assets they manage).

The transition managers estimated that approximately 60% of assets would be retained (essentially a nil cost transfer) and 40% of assets would need to be sold (and replacement holdings bought). Cost of trading of UK equities was estimated at £9.5 million (sell side) and £56.8 million (buy side). The high cost of the buy side is due to unavoidable stamp duty of 0.5% of the value of buy trades.

### Overseas equities

The transition manager made assumptions about the shape of portfolios of active global and overseas equity managers mandates (based on their knowledge of managers' portfolios from transitions they conduct and our breakdown of the largest managers of these mandates for the LGPS and the proportions of assets they manage).

The transition managers estimated that just over half (approximately 53%) of assets would be retained (essentially a nil cost transfer) and approximately 1% of the balance can be transferred between overseas and UK holding (dual listing). That leaves approximately 46% of overseas assets to be traded externally. Cost of trading of overseas equities was estimated at £42.7 million (sell side) and £42.0 million (buy side).

### Bonds

The bond transition involved a movement of approximately £17.6 billion of assets from active to passive mandates. For securities within these mandates, 32% of assets will be retained in the target portfolio. This leaves a net transaction of approximately £12 billion of buys and sells. The transition managers estimated a cost of £45 million for executing these trades.

## Summary

The estimate for transition costs from external to active management was as shown in table 22 opposite.

Based on aggregate LGPS assets of £180 billion, where the amount of listed assets is approximately £150 billion, the transition cost would result in a transition "slippage" amounting to just under 0.12% of LGPS assets.

**Table 22: Analysis of transition costs**

| Asset category | Transition cost £m |
|---|---|
| UK equities | 90 |
| Overseas equities | 87 |
| Bonds | 38 |
| **Total** | 215 |

### Potential variation in transition cost

It will be necessary to conduct further, more detailed, investigations of transition arrangements before any transition is conducted. This will include obtaining greater detail on the constituents of the current actively managed portfolios. Planning of the transition is vital. This will include elements such as phasing of tranches and timing between tranches.

In our financial analysis in Chapter 3, we have shown the sensitivity of financial outcomes, dependent on more prudent (i.e. higher) assumed transition costs.

### Comments

- The cost of transition may seem significant as an up-front cost but it is actually no more than the hidden additional turnover costs incurred in active management which will be saved by investing passively for just one year.
- No additional funding or up-front cash is required from government or from local authorities. Transition costs are met from the assets of the scheme and would be reflected in asset valuations (like other investment transaction and turnover costs).
- Even allowing for other implementation costs, the payback period (i.e. the period over which savings from the transfer from active to passive management will exceed the cost of transition) is likely to be just over **one year**.

# Appendix 2a Performance analysis

**All of the Fund performance data used in this Appendix is based on aggregate WM Local Authority data from State Street Investment Analytics (The WM Company).**

## Performance and correlation

### Overview

A summary of asset class performance is shown in tables 1 and 2. All performance is shown gross of managers' fees, but does reflect the cost of transactions and turnover. We provide additional information on each region and asset class in the following sections. General points to note include:

- In table 23, we have provided one, three, five and ten year performance to 31 March 2013. These represent a snapshot over time. There is overlap between these four time periods, e.g. the one year performance to 31 March 2013 is included in the all four figures quoted; the three year figures form part of the five year and ten year data.
- In table 24 we have provided performance for the four years to 31 March 2007, the two years to 31 March 2009 and the four years to 31 March 2013. This allows the analysis to show how Funds and markets performed going into, during and coming out of the financial crisis.
- Funds use a range of underlying benchmark indices. The indices shown in tables 1 and 2 provide an indication of relative performance; but will not necessarily reflect the benchmarks used by the underlying Funds; this is most notable for Global, Asia Pacific and Emerging Markets mandates, where a large number of benchmark indices exist.
- Each benchmark index operates with specific rules, e.g. treatment of taxes, timing of additions and exits from the index, approach to reinvesting dividends etc. Depending upon the specific rules, the index rules may not be practically replicated so would act as a headwind or they may create an opportunity to add value above the benchmark return (even if invested on a passive basis). As an example, UK pension funds can reclaim tax paid on dividends in some areas of the Pacific, whereas the index assumes that only dividends net of tax are reinvested. Typically, passive funds in the Pacific area can outperform the index by 0.2% p.a. purely on the basis of the tax reclaimable.
- The Funds' performance includes a combination of active and passive performance. It is reasonable to expect that asset classes with large allocations to active management would deviate further from benchmarks (in technical terms, have higher "tracking errors") than asset classes with large passive allocations.
- WM's data groups the Fund's conventional gilts and corporate bond holdings together, rather than separating them. In tables 1 and 2, we have shown the Funds' performance relative to both gilts and investment grade corporate bonds, reflecting the two main asset classes that are classified as "conventional" bonds.
- Funds may adjust their asset allocation from time to time. Depending on timing, this could have a positive or negative impact. To give an example, it would be possible for a Fund to outperform in every asset category but underperform its aggregate Fund index if its asset allocation positioning damaged returns to a significant extent (i.e. by being overweight in underperforming asset classes). The converse can also apply.

**Table 23: Summary performance (performance shown gross of fees to 31 March 2013)**

| | One year % | Three years %p.a. | Five years %p.a. | Ten years %p.a. |
|---|---|---|---|---|
| **UK equities** | 18.0 | 9.8 | 7.3 | 10.8 |
| **FTSE All Share** | 16.8 | 8.8 | 6.7 | 10.7 |
| ***Relative*** | *+1.1* | *+0.9* | *+0.6* | *+0.1* |
| **North American equities** | 19.0 | 11.4 | 10.5 | 8.4 |
| **FTSE North America** | 19.3 | 11.8 | 11.5 | 9.5 |
| ***Relative*** | *-0.2* | *-0.4* | *-0.9* | *-0.9* |
| **Europe ex UK** | 20.4 | 5.9 | 4.1 | 11.6 |
| **FTSE Europe ex UK** | 17.8 | 4.0 | 2.9 | 11.4 |
| ***Relative*** | *+2.2* | *+1.8* | *+1.2* | *+0.2* |
| **Japan** | 15.4 | 5.3 | 5.9 | 7.5 |
| **FTSE Japan** | 14.3 | 3.5 | 5.1 | 7.4 |
| ***Relative*** | *+1.0* | *+1.8* | *+0.8* | *+0.1* |
| **Asia Pacific ex Japan** | *19.2* | *9.3* | *11.4* | *17.3* |
| **FTSE Pacific ex Japan** | *18.1* | *8.9* | *10.7* | *16.4* |
| ***Relative*** | *+0.9* | *+0.4* | *+0.6* | *+0.8* |
| **Emerging Markets** | 10.5 | 4.3 | 6.8 | 17.1 |
| **FTSE Emerging** | 7.4 | 3.2 | 7.2 | 18.2 |
| ***Relative*** | *+2.9* | *+1.1* | *-0.3* | *-0.9* |
| **Conventional bonds** | 10.6 | 8.8 | 8.6 | 6.2 |
| **FTSE All Stocks** | 5.2 | 8.2 | 7.1 | 5.8 |
| ***Relative*** | *+5.0* | *+0.6* | *+1.4* | *+0.4* |
| **Conventional bonds** | 10.6 | 8.8 | 8.6 | 6.2 |
| **iBoxx Corp All Stocks** | 13.2 | 8.8 | 7.9 | 5.7 |
| ***Relative*** | *-2.3* | 0.0 | +0.6 | +0.5 |
| **Index-linked gilts** | 11.2 | 12.3 | 9.3 | 8.0 |
| **FTSE IL>5yr** | 11.8 | 13.0 | 9.1 | 8.3 |
| ***Relative*** | *-0.5* | *-0.6* | *+0.1* | *-0.2* |

**Table 24: Additional performance (performance shown gross of fees to 31 March 2013)**

| | 4 years to 31/03/07 % p.a. | 2 years to 31/03/09 % p.a. | 4 years to 31/03/13 % p.a |
|---|---|---|---|
| **UK equities** | 21.1 | -19.6 | 19.1 |
| **FTSE All Share** | 21.1 | -19.3 | 18.3 |
| ***Relative*** | *-0.1* | *-0.5* | *+0.6* |
| **North American equities** | 10.0 | -11.8 | 18.5 |
| **FTSE North America** | 10.8 | -9.5 | 18.9 |
| ***Relative*** | *-0.8* | *-2.5* | *-0.3* |
| **Europe ex UK** | 24.7 | -15.9 | 15.0 |
| **FTSE Europe ex UK** | 25.5 | -15.6 | 13.6 |
| ***Relative*** | *-0.6* | *-0.3* | *+1.2* |
| **Japan** | 16.6 | -15.2 | 11.6 |
| **FTSE Japan** | 17.0 | -13.0 | 9.5 |
| ***Relative*** | *-0.3* | *-2.4* | *+1.9* |
| **Asia Pacific ex Japan** | *26.7* | *-6.0* | *21.2* |
| **FTSE Pacific ex Japan** | *25.3* | *-7.5* | *21.2* |
| ***Relative*** | *+1.2* | *+1.7* | *-0.1* |
| **Emerging Markets** | 31.6 | -8.0 | 17.5 |
| **FTSE Emerging** | 32.9 | -5.7 | 17.7 |
| ***Relative*** | *-1.0* | *-2.4* | *-0.1* |
| **Conventional bonds** | 4.0 | 1.9 | 10.7 |
| **iBoxx £ Overall** | 4.4 | 2.6 | 8.6 |
| ***Relative*** | -0.4 | -0.7 | 2.0 |
| **Index-linked gilts** | 5.6 | 4.9 | 12.2 |
| **FTSE IL>5yr** | 6.0 | 5.0 | 12.4 |
| ***Relative*** | *-0.3* | *-0.1* | *-0.2* |

### Asset class and regional performance comments

Annual performance (12months ending 31 March of each year) and cumulative performance information are included later in this appendix (performance is shown for each asset class, relative to the underlying index over the past ten years). Points to note include:

- The Funds' information is based on aggregate performance. It does not show the level of dispersion between underlying Funds' and their managers' performance.
- Asset class performance has exhibited considerable volatility of recent years. This is reflected both in the absolute returns that have been generated, and in the relative returns.
- At a regional level, Funds' relative equity performance was poor during the build up to the credit crisis (2003-2007), with underperformance in UK, North America, Europe ex UK, Japan and emerging markets, and outperformance only being achieved in Asia Pacific. Part of this outperformance arises because funds can reclaim tax paid on dividends in some countries, whereas the benchmark assumes net dividends.
- Funds also struggled in the volatile markets witnessed during the credit crisis (i.e. 12month periods to 31 March 2008 and 31 March 2009). North America, Japan and emerging markets equities underperformed benchmark returns in both of these years and the UK and Europe underperformed in at least one of these years and over the two year period in aggregate.
- Over recent years there are signs of improved performance. Over the most recent 12 months, the analysis suggests there has been outperformance in the UK, Europe ex UK, Japan, Asia Pacific and Emerging markets. North American has continued to prove to be a difficult market for Funds to add value above the index.
- As a whole, Funds' index-linked gilts portfolios have struggled relative to the market return, under-performing in seven out of the past ten years and only outperforming in two years. There has also been underperformance in each of the three time periods shown in table 24 - reflecting the performance pre, during and post the financial crisis.
- Given the nature of WM's data, it is difficult to draw too many conclusions relating to Funds' conventional bonds. The WM data does not outline the precise mix of the underlying holdings are (they will be largely gilts and corporate bonds) or the proportions of assets that each category represents or the nature of these holdings e.g. duration, credit criteria, etc.

  Relative to the composite index (iBoxx £ Overall) that we have used in this appendix, Funds have tended to be overweight corporate bonds and underweight gilts; further, within corporate bonds, they have tended to be overweight in lower graded issues compared with the benchmark. This disposition explains benchmark outperformance in the last 4 years.

  We are also aware that Funds' corporate bond performance was very volatile during the credit crisis and the dispersion of returns achieved by Funds over that period was particularly wide.

## Correlation analysis

The following three year Fund and index return correlations are shown below:

- Total equities (chart 2)
- Regional equities (chart 3)
- Bonds (chart 4).

**Chart 2: Total equities**

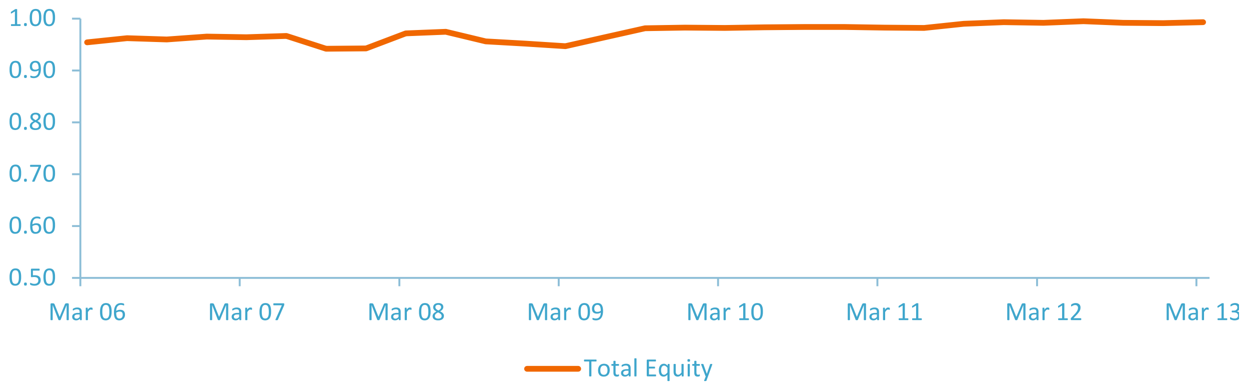



**Chart 3: Overseas equities**

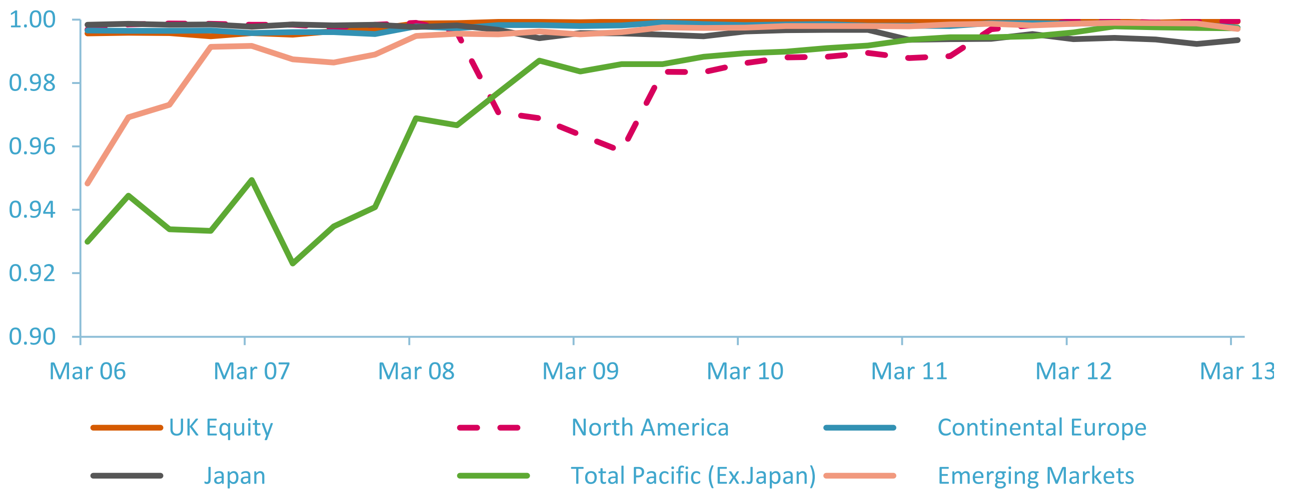
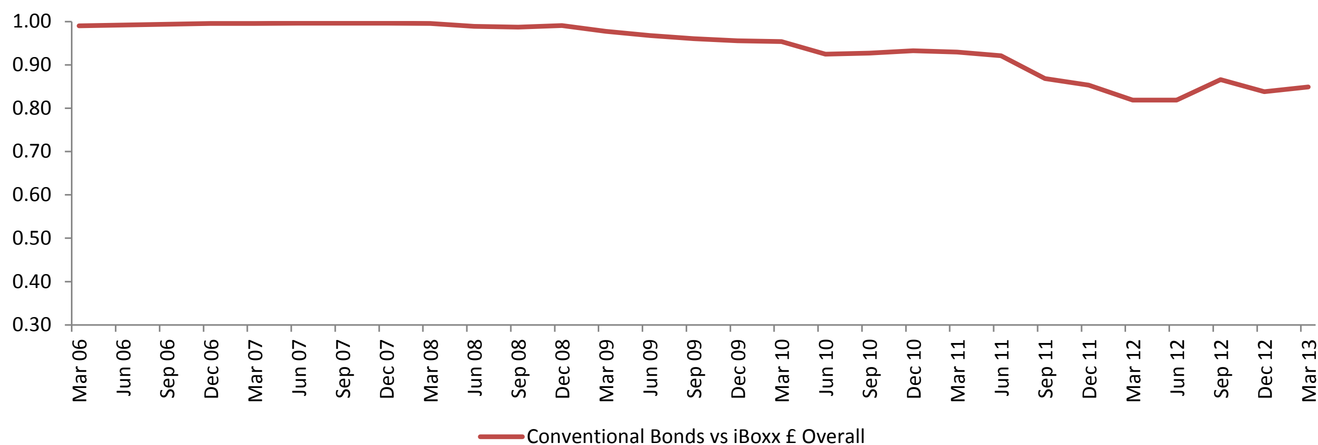


**Chart 4: Conventional bonds and iBoxx £ Overall**




- Correlation data provides an indication of strength of the relationship between the Funds' returns and underlying index returns. It does not provide any information of the scale of the relative moves. For example, even the returns of a highly active equity manager are likely to highly correlated with the broad market index, e.g. in excess of 0.8. Given this, we believe there are only limited conclusions that can be drawn from looking at the correlation data in isolation.
- The correlation of the Funds' aggregate equity returns, with the broad market index, tends to be very high (in excess of 0.9). This should be expected because:
  - There will be considerable overlap between the Funds' and index holdings, in particular the larger stocks that tend to be key drivers of risk and returns.
  - Regional equity markets tend to be highly correlated over time; therefore any regional differences between the Funds and the broad benchmark index should have limited impact on any correlation analysis.
- The correlation of the Funds' regional returns with the broad market indices also tends to be high. This is particularly notable for North American, Japanese, UK and European equities. This is again largely due to the high level of overlap between the Funds' and index holdings.
- Asia Pacific and emerging markets correlations tend to be lower than other regional markets. This is due largely to the more diverse nature of these mandates i.e. Funds use a number of different Asia Pacific and emerging markets benchmarks, each of which include different countries and stocks. These benchmark differences can have significant impacts on returns. Nevertheless, whilst the correlations are lower than other regions, they remain high, in excess of 0.9.
- Over recent years there has been a notable increase in correlations between regional markets and their underlying indices, suggesting that key drivers of the performances of Funds and indices are now more closely aligned.

  In chart 4 we show the correlation of Funds' conventional bond returns, relative to an aggregate index (iBoxx £ Overall) of gilts and UK investment grade corporate bonds. As shown, the correlation has reduced following the Global Financial Crises as managers have moved underweight in gilts relative to the benchmark index and correspondingly overweight in corporate bonds, and more lowly-rated investment grade corporate bonds relative to the benchmark index.

**Performance figures (12 months to 31 March, and 3, 5 and 10 years to 31 March 2013)**

**Chart 5: UK equities**

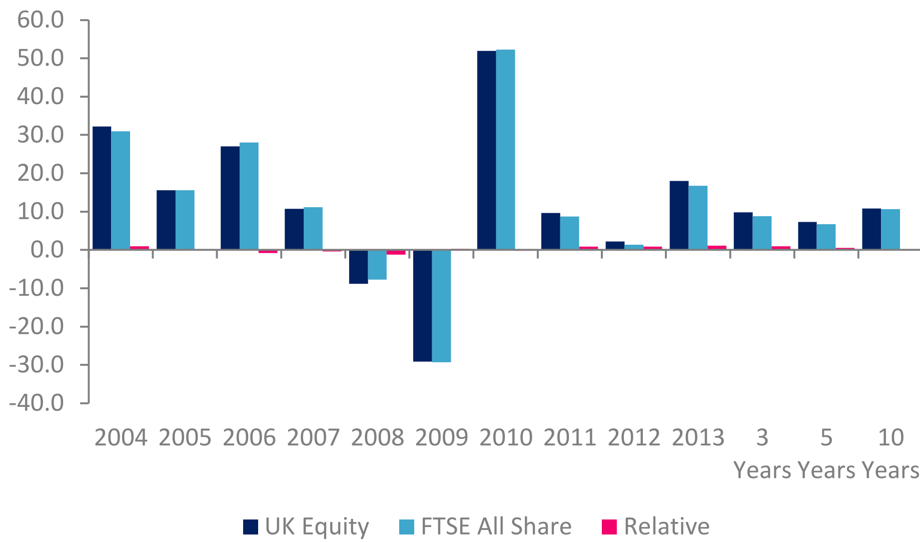



**Chart 6: North American equities**

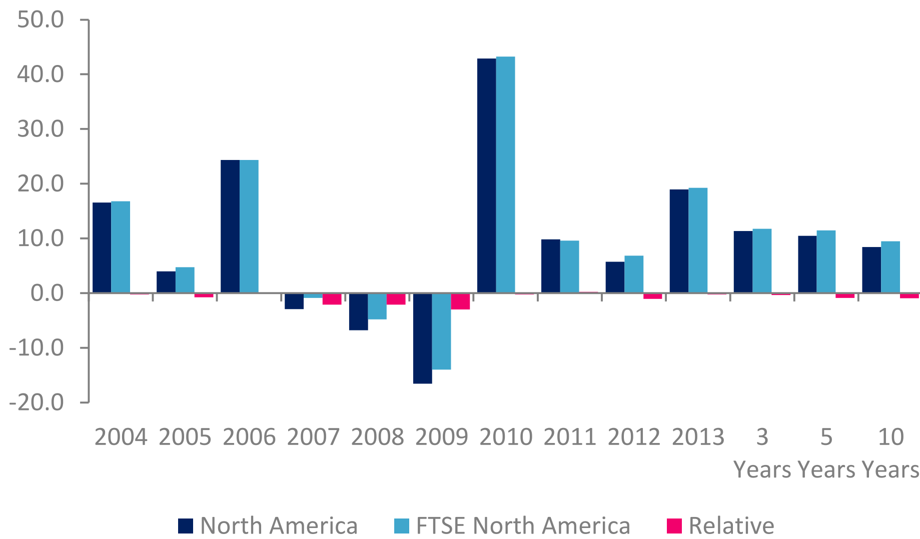


**Chart 7: Europe ex UK equities**

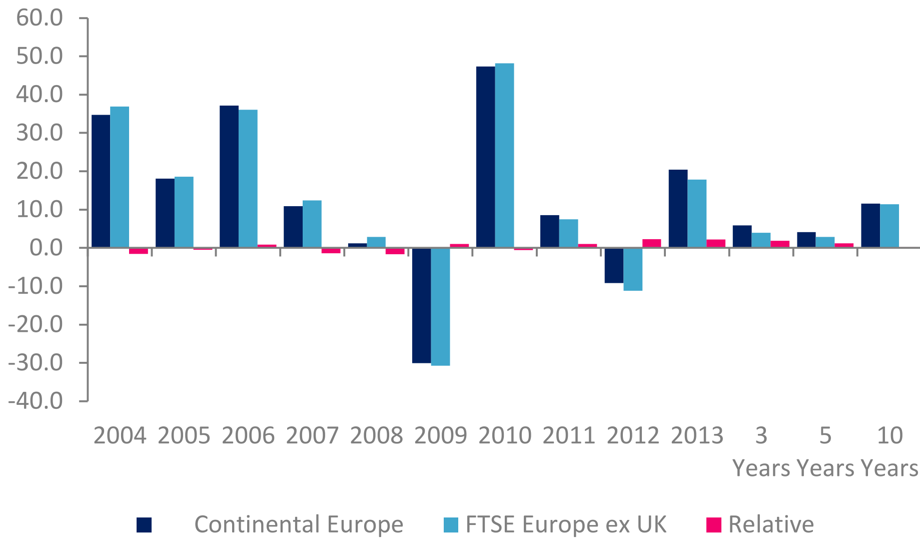



**Chart 8: Japanese equities**

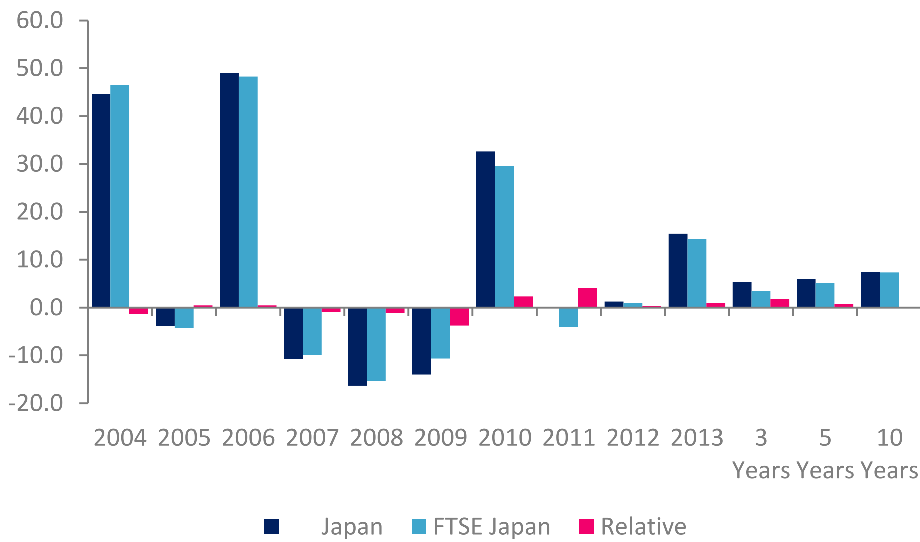


**Chart 9: Asia Pacific equities**

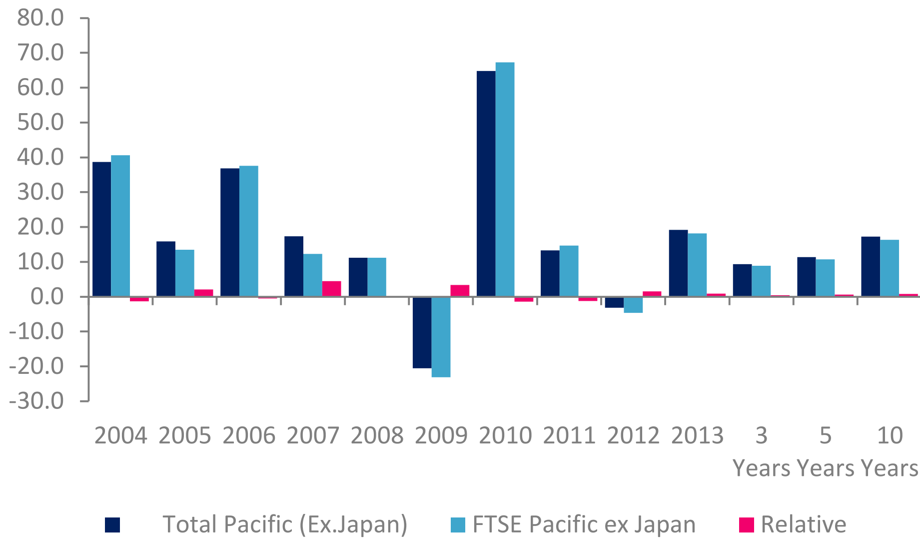



**Chart 10: Emerging markets equities**

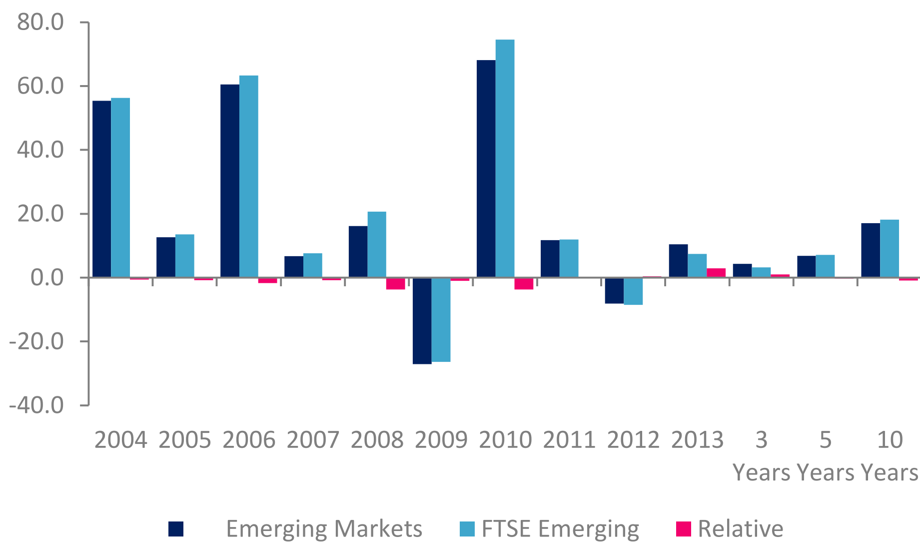


**Chart 11: Conventional bonds versus composite UK bonds (iBoxx £ Overall)**

Since mid-2009, funds have typically held less in gilts and more in corporate bonds than the benchmark index and have typically held lower grades of corporate bonds than the index

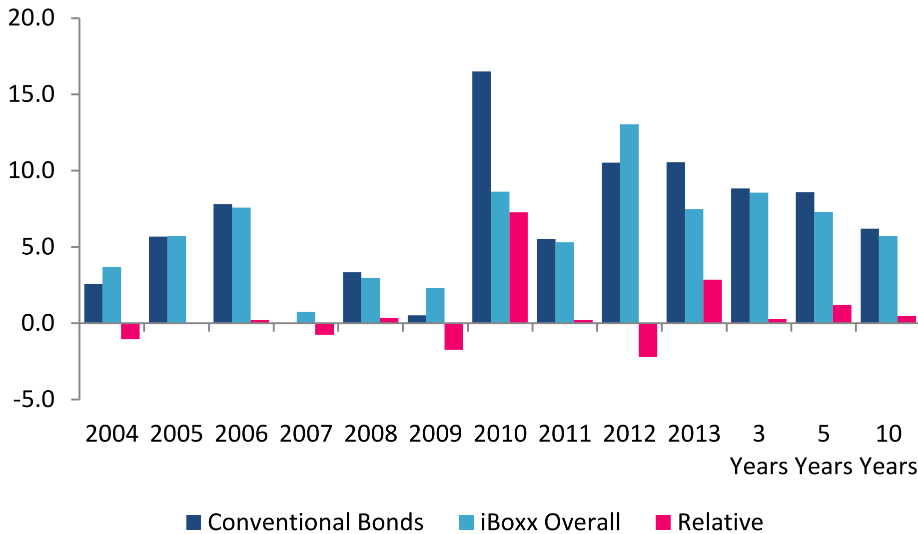
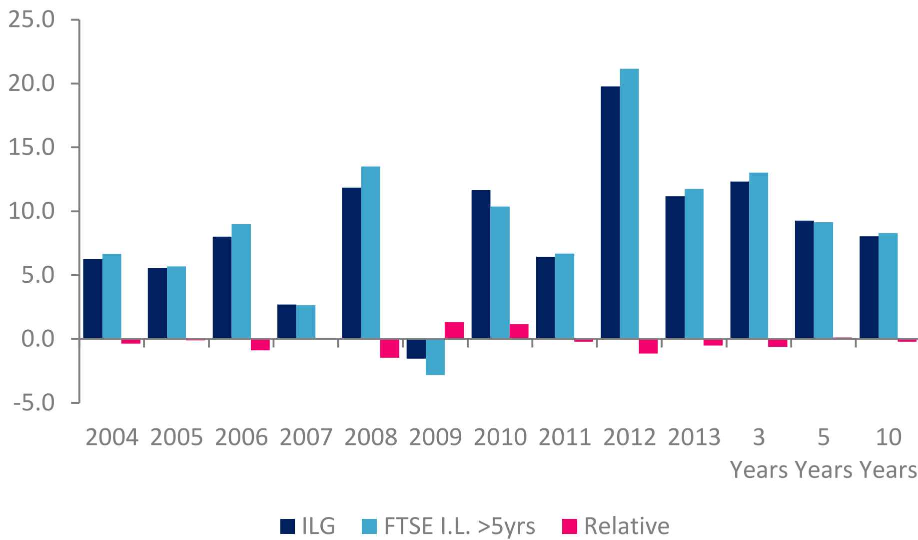
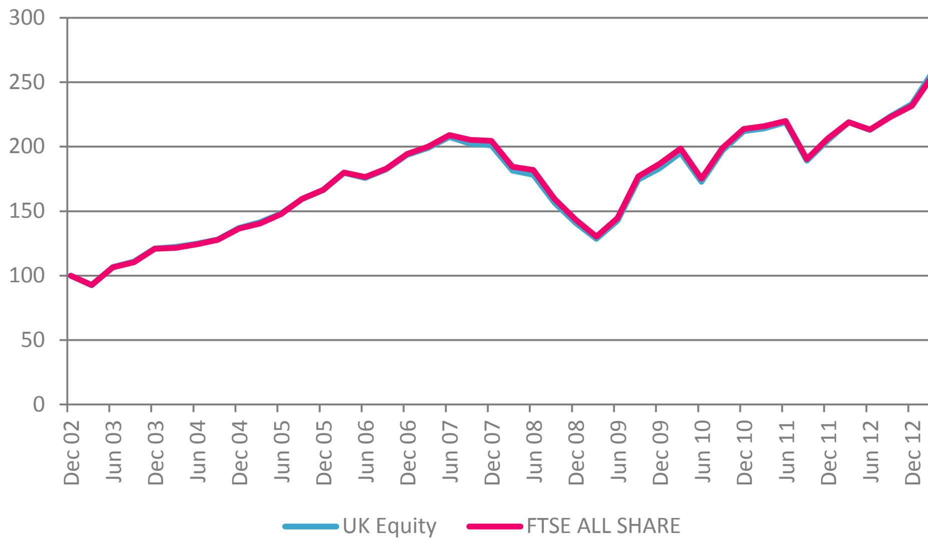



**Chart 12: Index-linked bonds**



## Cumulative performance

### Chart 13: UK equities




### Chart 14: North American equities

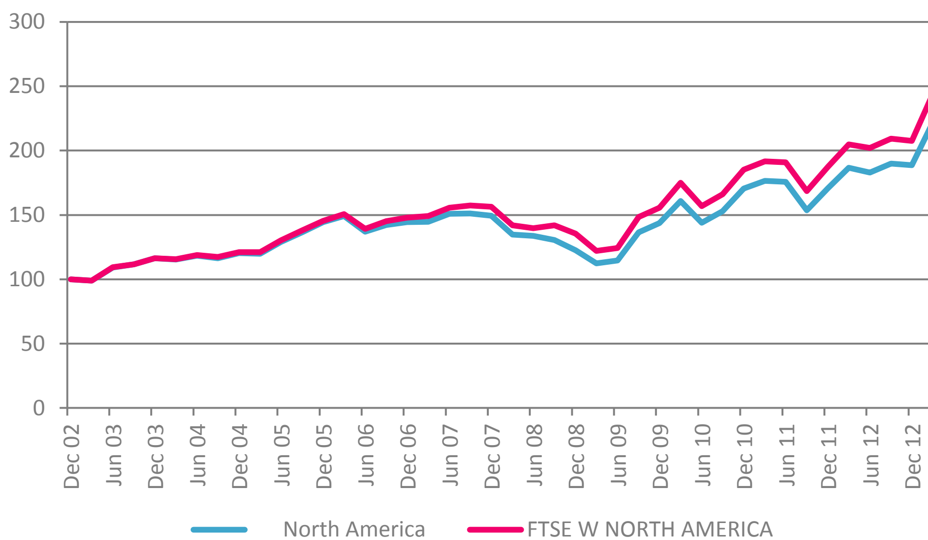


**Chart A15: Europe ex UK equities**

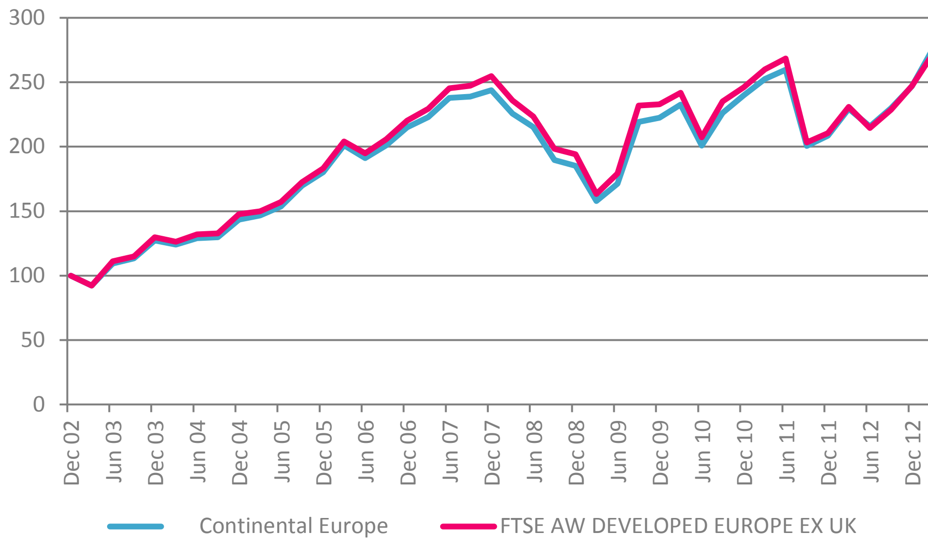



**Chart A16: Japan equities**

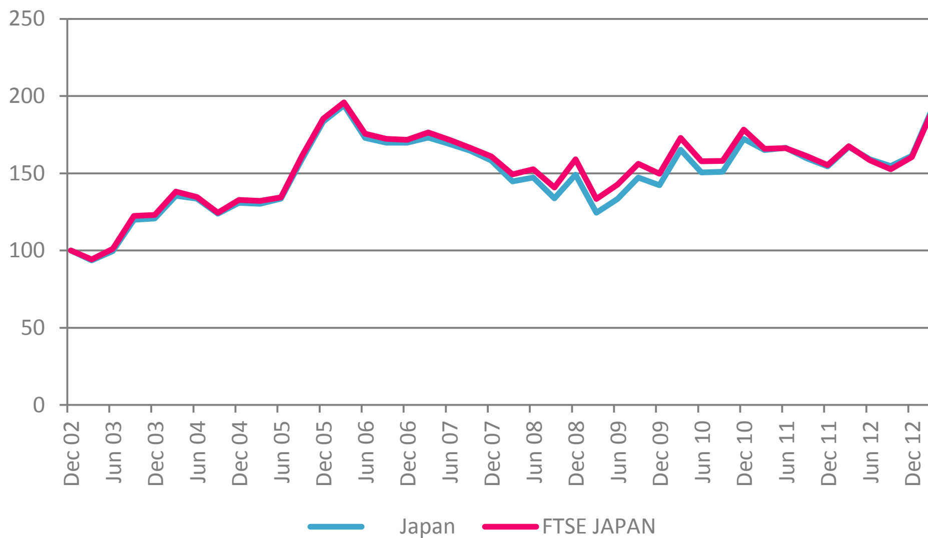


**Chart A17: Asia Pacific ex Japan equities**

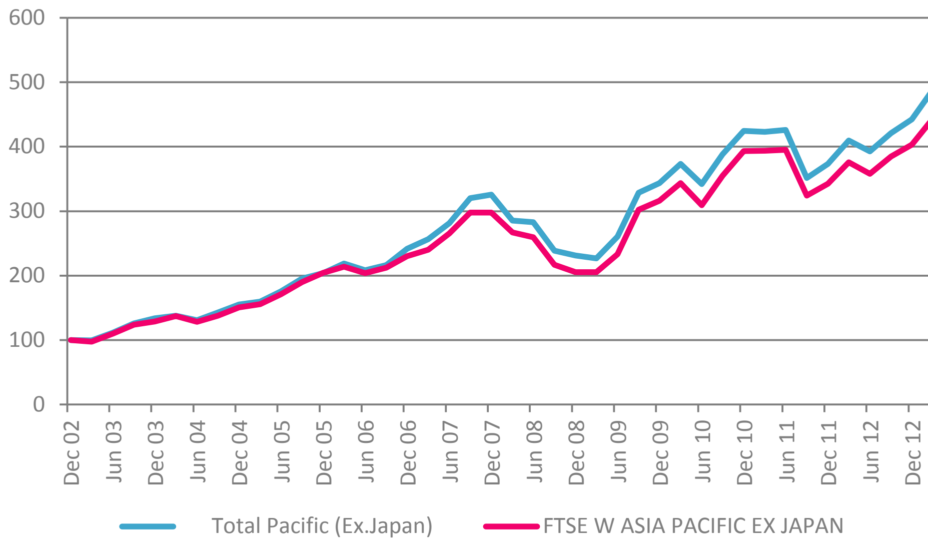



**Chart A18: Emerging markets equities**

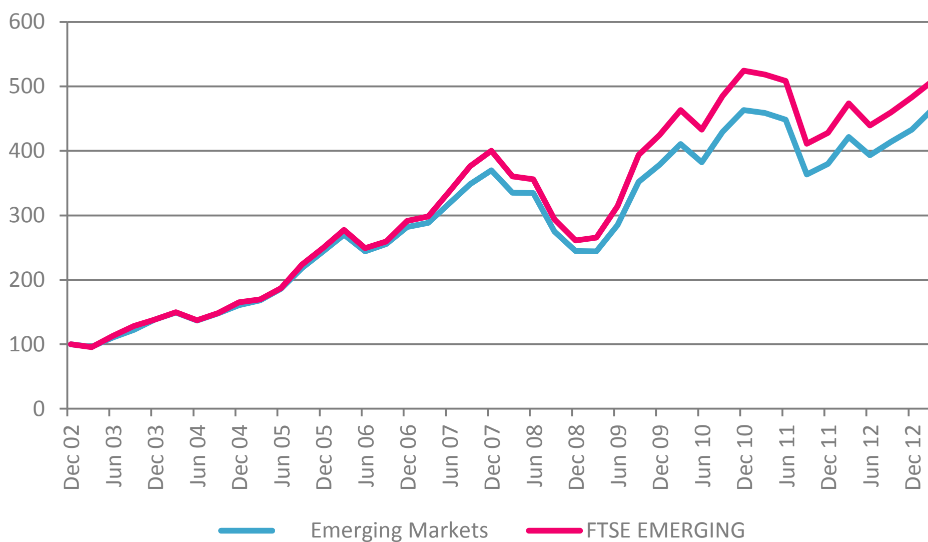


**Chart A19: Conventional bonds versus government gilts and corporate bonds**

Since mid-2009, funds have typically held less in gilts and more in corporate bonds than the benchmark index and have typically held lower grades of corporate bonds than the index

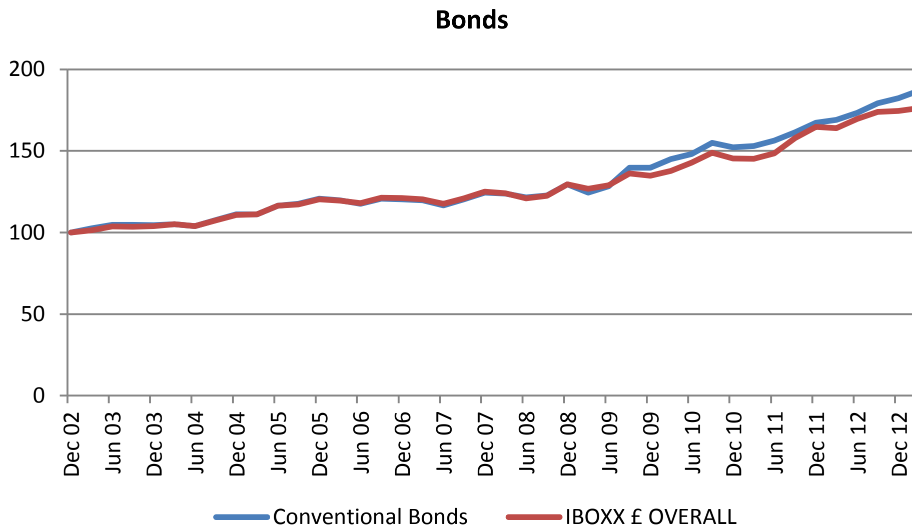
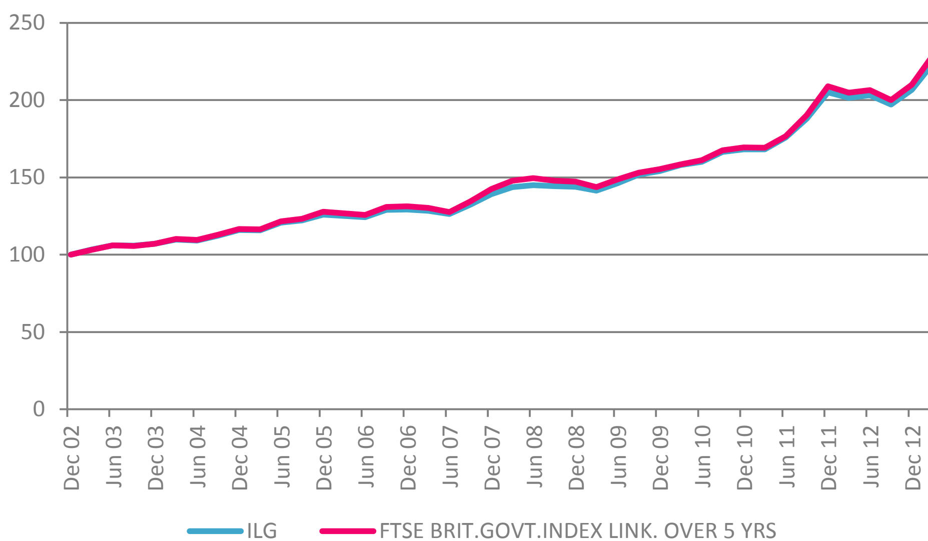


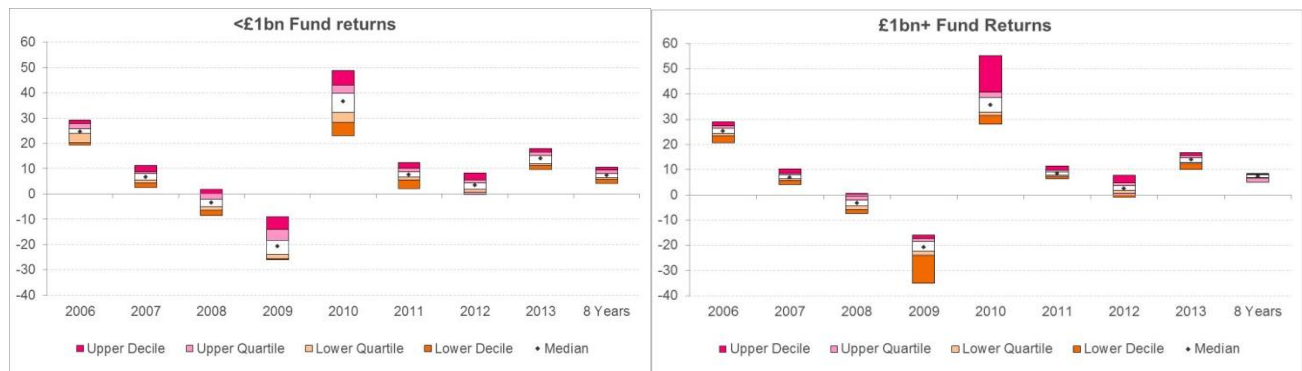

**Chart A20: Index-linked gilts**



# Appendix 2b LGPS performance dispersion, small and large

**All of the Fund performance data used in this Appendix is based on data gathered by Hymans Robertson from data in the public domain (e.g. Funds' annual reports and accounts).**

The leftmost bars in each of the charts below shows the spread of returns in each financial year from 2005-06 to 2012-13, indicating the top 10, top quartile, median, bottom quartile and bottom 10. The rightmost bar shows the spread of returns for the cumulative 8-year period. The chart on the left includes all of the LGPS funds that are less than £1bn and the chart on the right is the funds over £1bn.




The median return over eight years for the smaller funds was 7.2% p.a. and for the larger funds it was 7.4%. Although there is no strong evidence of better performance by larger funds there is evidence of a wider dispersion of returns for the smaller funds, particularly in the critical years, 2008/09 and 2009/10 around the credit crunch.

### Characteristics of funds in the top 10

- These funds use a limited number of managers (typically 1-3 managers with balanced mandates focused on equities and bonds);
- They retain their managers for the long term, even through inevitable periods of underperformance;
- They adopt a simple structure focused on equities, bonds and property;
- They make limited use of alternatives;
- Some use internal management; and
- There is evidence they rebalanced assets back to benchmark over 2008/09 as equity markets collapsed; this enabled full participation in the equity market rebound in 2009/10

# Appendix 6a Analysis of available fund structures for one or more common investment vehicles Squire Sanders

## 1 EXECUTIVE SUMMARY

1.1 This section of our Report is in three parts:

(a) a legal analysis of the Investment Regulations and the restrictions contained in them on five English law CIV structures which may be held by LGPS funds;

(b) an analysis of the key regulatory and tax features of those CIVs; and

(c) a summary of the procurement and potential competition law implications of LGPS funds subscribing for investments in new CIVs.

1.2 A Glossary of terms used in the Executive Summary and the analysis is found at the end of Section 1. It should be noted that our conclusions are based on the law as it currently stands at the date of this Report. The law may and no doubt will change and evolve and therefore care should be taken to ensure our conclusions remain valid in that event.

**Investment Regulations**

1.3 The Investment Regulations currently constrain LGPS funds' investment powers by reference to some but not all of the available structures and do so by reference to the legal form of the vehicle. Those Regulations impose maximum holding limits of between 30% and 35% and may limit investments in other vehicles which are not expressly mentioned in the Regulations by virtue of a single holding limit of 10%. These limits can be repealed or amended by secondary legislation under powers given to the Secretary of State by the Superannuation Act 1972.

1.4 The power of investment of an LGPS fund is vested in the administering authority ("AA"). As such, since there is no power for another person, such as the Secretary of State, to exercise that function or direct how the power is used. AAs cannot be compelled to exercise their discretion to invest in a CIV (or any other instrument). The legislative means by which such a power could be given to another body is also by secondary legislation under the same Act.

**Summary of CIV key features**

1.5 The key features of each of the five CIVs (a Unit Trust (UT), Open Ended Investment Company (OEIC), Limited Partnership (LP), Authorised Contractual Scheme (ACS) and Unit Linked Life Fund) have been analysed on the assumption that new vehicles might be set up which could be tailored to LGPS funds (and any private sector funds which chose to invest in such funds). It may be that an existing insurance company could offer existing unit linked life funds or create new unit linked life funds for these purposes, which would save time and potentially capital, especially since three of the major players in the passive management field (Legal & General, BlackRock and State Street Global Advisors) each have current LGPS assets under management in such funds. We have not considered the implications of using existing vehicles in this Report nor have we carried out any due diligence on any such vehicles, so this is no more than a factual observation. There are also potential competition and procurement law issues which need to be addressed.

1.6 Because of the way that the Investment Regulations currently require OEICs to be authorised as UCITS compliant funds to maximise an LGPS fund's holdings in any single OEIC, we have assumed that only

such an authorised and UCITS compliant OEIC fund would be established. Although the regulatory régime is different, a comparable analysis necessarily applies to a unit linked life fund, because there is only one financial services model available.

1.7 The same regulatory hurdle of being UCITS compliant does not apply to the other vehicles (i.e. UTs, LPs or ACS), at least as far as the way the Investment Regulations restrict their usage. That is not to say that these vehicles can be used in a completely unregulated way, since the manager/operator and the depositary must be authorised under the AIFMD. The complexity of the financial services authorisation options for each of these vehicles is beyond the scope of this Report, but in summary, each collective investment scheme established under either section 235 or 235A of the Financial Services and Markets Act 2000 may be established on a number of different bases, broadly depending on the type of investor that the scheme is aimed at. UCITS may be marketed to retail investors but are accessible by professional investors also (i.e. including LGPS funds).

1.8 There are further categories of authorised fund which benefit from less rigorous rules which could be used for professional investors such as LGPS funds: these include the Non-UCITS Retail Scheme ("NURS") and the Qualified Investor Scheme ("QIS"). We have assumed for the purposes of this Report that the last of these vehicles, the QIS, is the most appropriate model to use for UTs, LPs and ACS, since it preserves the maximum flexibility and has the least regulatory burden. If further analysis of the UCITS and NURS options is required, we can of course revise our advice.

1.9 The broad parameters of our analysis are set out below; more detailed discussion is found in the table in the Annex.

1.10 There are, in the final analysis, a limited number of distinguishing features which would lead to the conclusion that a particular legal model is superior to the others.

(a) **Regulator** - under each CIV there is a need for authorisation under FSMA. For a unit trust, OEIC, LP and ACS the regulator will be the FCA. For unit linked life funds the prudential regulator, the PRA, supervises insurance companies. The life company regime is more complex than the supervisory regime for the other CIVs.

(b) **Timing** – whilst it is difficult to put an estimate on preparation time, the timescales for authorising an investment or fund manager are significantly shorter than establishing a new insurance company. Setting up a new unit-linked fund, however, involves comparable if not shorter timescales than for a new fund under the other structures. Use of existing vehicles (if appropriate) will of course reduce timing considerably.

(c) **Regulatory Capital** – regulatory capital requirements for life companies are significantly higher than for fund or investment managers. The regime is more complex and subject to change due to Solvency II in 2016 (with full implementation expected by 2019).

(d) **Ownership of the underlying assets** - of the five vehicles the OEIC and the life company vehicles each represent structures by which the legal and beneficial ownership of the underlying assets is separated from the investors (i.e. LGPS funds). In a UT, the trustee owns the assets on trust for the investors. In both the LP and the ACS legal ownership of the underlying assets remains with the CIV (because it has no separate legal personality from that of its investors). In all cases the CIV will contract with third parties through the operator of the CIV.

The retention of legal ownership under the LP and ACS models does not, however, mean that the investors control the underlying assets, since day to day control of the securities or other investments is a function which will need to be delegated to an authorised third party, ie a

custodian bank (called a depositary). Indeed, partnership law prevents limited partners from playing any part in management of an LP without losing limited liability status.

(e) **Tax transparency on the underlying assets** – The LP and ACS models are the only vehicles that have tax transparency as a key feature of their design. Separate regimes exist for authorised UTs and OEICs. A life company owns its assets and benefits from a general exemption from tax on its pension fund business.

(f) **Stamp Duty/SDRT** – All vehicles have favourable stamp duty tax treatment on transfers within the CIV. There is no distinction between stamp duty liability on purchases of equities and real estate by the CIV: all are subject to stamp duty although the initial transfer of securities into an ACS has been granted a specific exemption.

(g) **VAT** – Authorised OEICs have favourable VAT regimes with no VAT on management fees. Insurance services are VAT exempt and irrelevant to an internally managed unit-linked life fund in any event. The UT, LP and ACS models also have favourable VAT exemptions.

(h) **Withholding taxes (WHT)** - a detailed analysis of the efficiency of each vehicle to recover WHT on overseas investments is beyond the scope of this Report because it will depend on where the underlying assets are held. There may be differences in certain jurisdictions because of the recognition of the legal form of the CIV.

(i) **Counterparty risk**- a key consideration is what rights investors have in the event of insolvency of the provider/operator of the CIV since that is the counterparty (the insolvency risk attaching to underlying issuers of securities held by the vehicle is of course the same regardless of the vehicle). The only CIV that has a separate insolvency regime is that which applies to insurance companies, by which eligible policyholders are given priority over unsecured creditors. None of the other vehicles offers this preferential creditor status as the LGPS investor would be unsecured in the absence of express security being granted by the CIV (this would not legally be possible in an LP or ACS anyway, given that those vehicles have no separate legal personality) . In a UT, OEIC, LP or ACS where the assets are held by a depositary, the counterparty exposure is really therefore to the depositary holding the assets.

Note that the Financial Services Compensation Scheme is not available to LGPS investors.

(j) **Segregation of liability at a sub-fund level** – UTs, LPs and unit linked life funds do not offer segregated cells or sub-funds, meaning that the assets and liabilities of one sub-fund could suffer contagion if another sub-fund were to default. OEICs and ACS contractual schemes offer sub-fund options and segregation recognised under insolvency laws.

(k) **Investment objectives and restrictions** – because of the manner in which the Investment Regulations treat an OEIC (i.e. as a UCITS which has a maximum investment holding of 35% by an LGPS fund), that vehicle is disadvantaged in terms of its investment restrictions. Unit-linked life funds may only be provided on a regulated basis and so are also subject to permitted links rules which prescribe the assets that can be used to count against the solvency capital of the insurer. The UT, LP and ACS can all therefore benefit from more investment freedom than is prescribed under the UCITS directive.

1.11 **Procurement** – The potential concentration of assets under a new CIV or CIVs needs careful analysis to ensure that the procurement law impact of the establishment of new CIVs is not under-estimated. The identity of the operators of any new CIVs and the nature of the vehicles will determine these questions. We have therefore described in outline the parameters of public procurement by reference to the CIVs discussed in this Report.

## GLOSSARY

| | |
|---|---|
| **ACD** | **Authorised Corporate Director (of an ICVC or OEIC)** |
| **ACS** | **Authorised Contractual Scheme established pursuant to the ACS Regulations** |
| **ACS Operator** | **the person authorised under FSMA to manage an ACS** |
| **ACS Regulations** | **Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013** |
| **AFM** | **Authorised Fund Manager (meaning a legal entity authorised under FSMA to manage a fund)** |
| **AIFM** | **Alternative Investment Fund Manager (to be authorised by FCA effective 22 July 2014)** |
| **AIFM Regulations** | **Alternative Investment Fund Managers Regulations 2013** |
| **AIFMD** | **Alternative Investment Fund Managers Directive** |
| **AUT** | **Authorised Unit Trust (meaning authorised by FCA)** |
| **CIS** | **a collective investment scheme under section 235 FSMA (including OEIC, UT, ACS, UCITS and UCIS)** |
| **CIV** | **a CIS and unit-linked life fund or pension fund management insurance contract** |
| **COLL** | **FCA's Collective Investment Schemes handbook of rules and guidance** |
| **Depositary** | **the name for the custodian of the ICVC (FCA and/or PRA authorised)** |
| **FCA** | **Financial Conduct Authority** |
| **FSMA** | **Financial Services and Markets Act 2000** |
| **Investment Regulations** | **LGPS (Management and Investment of Funds) Regulations 2009** |
| **ICVC** | **Investment company with variable capital established pursuant to the Open-ended Investment Companies Regulations 1997** |
| **LP** | **Limited Partnership** |
| **NAV** | **Net Asset Value** |
| **NURS** | **Non-UCITS Retail Scheme (which can be either an ICVC or UT)** |
| **OEIC** | **generic name for ICVC** |
| **PAIF** | **Property Authorised Investment Fund, a regulated ICVC principally intended for property investment (structured as a NURS – not a UCITS)** |

| | |
|---|---|
| **PRA** | **Prudential Regulation Authority** |
| **QIS** | **Qualified Investor Scheme, being an FCA regulated fund for professional investors and not falling under UCITS or NURS regimes** |
| **Solvency II** | **the EU measures to enhance insurer capital requirements, governance and disclosure obligations** |
| **Trustee** | **the name of the trustee of a unit trust (FCA and/or PRA authorised) including a trustee of a UCIS structured as a trust** |
| **TR13/8** | **the FCA's report on unit-linked life fund governance** |
| **UCIS** | **generic term meaning Unregulated Collective Investment Scheme (falls within section 235 FSMA)** |
| **UCITS** | **ICVC or UT scheme meeting the requirements of the Undertakings for Collective Investment in Transferable Securities Directive (as amended)** |
| **UT** | **Unit Trust** |

## 2 IMPACT OF THE INVESTMENT REGULATIONS ON CIV STRUCTURES

### INTRODUCTION

The Investment Regulations impose, under Regulation 14(2) and Schedule 1, various restrictions on different types of investment vehicle. Those limits may be increased if the AA complies with Regulations 14(3) and 15. For the purposes of this report and all of the options, the collective investment vehicles ("**CIVs**") that most readily allow for pooling of assets are as follows.

| **Vehicle** | **Maximum Limit**<br>**% of Fund** |
|---|---|
| Limited Partnerships ("**LP**") | 30% |
| UTs managed by one body | 35% |
| OEICs managed by one body | 35% |
| UT/OEIC managed by the same body | 35% |
| Any single unit-linked or pension fund management insurance contract | 35% |

**Notes:**

1 The 35% restriction does not apply if the unit trust or OEIC invests, inter alia, in gilts.

2 An OEIC is defined by reference to the UCITS Directive, so an unauthorised investment company which does not comply with that Directive is subject to a separate lower limit which applies to unlisted securities of 15%.

3 In reality, a life insurance contract would have to be unit linked rather than a pension fund management contract as the latter is designed to be used for a discretionary investment management portfolio and would not be capable easily (if at all) of being issued in joint names of such investors.

4 All of the above limits apply at the time of the original investment. There is no comparable ongoing maximum requirement if, for example, the value of the holding increases by reference to other asset classes.

5 The Investment Regulations also make reference to the ability for LGPS funds to coinvest in a scheme approved by the Treasury under section 11(1) of the Trustee Investments Act 1961 "without any restriction as to quantity". To our knowledge only one such scheme has ever been approved (a CCLA property fund which holds approximately £80m of assets). We have not considered this apparently arcane power further as the regulatory framework is unclear.

## 3 IMPLICATIONS

3.1 The practical implications of the Investment Regulations remaining in place with the above limits for all three Options under consideration are as follows.

3.2 Notwithstanding the general power of competence under section 1 of the Localism Act 2011, the existence of the Schedule 1 limits operate as restrictions on LGPS funds.

3.3 The limits apply asset allocation limits (and thus diversification) by reference to legal vehicle types; they do not therefore directly apply to asset allocation by reference to, say, strategic allocation to global equities. Thus, it is possible to comply with the limits without diversification, e.g. a 100% listed equity portfolio which is directly invested only carries a single but separate holding limit of 10% in any one stock. However, even that limit is removed (by note 2 to the table in Schedule 1) if the investment is made by an investment manager appointed by the Authority and the single holding is in units of a unit trust.

3.4 Several forms of collective investment vehicle are not defined or listed expressly under Schedule 1. These include the new contractual co-ownership scheme model that came into force under theACS Regulations, although the limited partnership model available under those Regulations is, of course, already catered for. Other undefined vehicles missing from Schedule 1 and not otherwise defined expressly in the rest of the Investment Regulations include Luxembourg vehicles (SICAV, SICAR and FCP) and Irish common contractual schemes. All of these are used already by LGPS funds.

3.5 To the extent that such undefined vehicles do not fall within the named categories of restricted investments in Schedule 1, it may be possible to characterise them under an existing heading. This is the case for an ACS established as an LP. If there is no appropriate characterisation for an ACS established on a tenants in common basis[7], it may be capable of being held in an unrestricted way (as described in paragraph 3.3 above). There is an argument that such an ACS may, however, be subject to the 10% single holding limit. "Single holding" is defined in the notes to the table in Schedule 1 as "investments" [itself an undefined term]:

(a) in securities of, or in loans to or deposits with, any one body;

(b) in units or other shares of the investments subject to the trust of any one unit trust scheme; or

(c) in transactions involving any one piece of land or other property.

3.6 Given the novelty of the ACS as a vehicle (none has yet been established or authorised by the FCA) it is not possible to be definitive that, despite its clear status under section 235A of FSMA as a collective investment scheme (which clearly is an investment under any normal meaning), an ACS itself satisfies any of the above three categories which apply to single holdings. It would depend in large part on the form of the documentation constituting the ACS.

3.7 If an ACS can be constructed so as to avoid any of these single holding definitions applying, it would be necessary to consider whether the transparency of the vehicle means that the single holding test requires one to look through the ACS (which after all has no separate legal personality, so does not block a look through approach) to any underlying securities, units or land/property. If, in keeping with the approach taken elsewhere in the Investment Regulations, a look through is not necessary, it may be possible to invest in an ACS without limit.

**[7] For the purposes of this appendix , references to an ACS are, unless otherwise stated, to a tenants in common structure.**

3.8 The consequence of this requirement to categorise investment vehicles by legal type and whether or not the investment is listed or not will of course have a direct bearing on the number of different CIVs that an individual LGPS fund may invest in. The lowest number of CIVs that an LGPS fund may already currently invest in is three (using the 35% limit applicable to unit trusts, OEICS and life company funds).

**Conclusion**

3.9 In conclusion, it is possible to circumvent the limits and have an undiversified portfolio, with heavy concentration of asset and counterparty risk under the current regulatory framework. Whatever outcome is decided upon as a result of this Report, one key recommendation we would make is to reconsider the efficiency of the Investment Regulations in controlling risk, as the asset allocation limits in Schedule 1 do not do this in any sophisticated way and lead to additional expenses in many instances to use vehicles which circumvent Schedule 1 limits.

## 4 ANALYSIS OF CIV STRUCTURES

4.1 Leaving aside the maximum limits imposed by the Regulations, not all CIVs have the same governance, capital or tax features. A number of more fundamental complex factors are set out in the matrix in the table below. For instance, is it more important to have CIVs which have maximum investment freedom or is the governance and tax structure more important? Is it important for investors to own the underlying assets and not have to assert a contractual right against the CIV in the event of an insolvency of an underlying investment? Such questions need to be tempered by a realistic understanding of the legal rights on counterparty default.

4.2 We have not attempted to score the factors that we have identified as applying to each vehicle in terms of investor suitability but that could of course be done.

4.3 We have limited the analysis to those CIVs referenced in the Investment Regulations and the ACS alternatives. This is not because other CIVs are not eligible investments for LGPS, but simply because their treatment under the Investment Regulations is that the lower 15% investment limit applies for such entities if they have to be regarded as investments in unlisted securities (where the limit is 15% in aggregate) or the 10% single holding limit (unless they fall outside the Investment Regulations altogether).

## 5 IMPACT OF THE AIFMD

5.1 AIFMD was implemented in the UK with effect from 22 July 2013 by the AIFM Regulations. It effectively implements a new regulatory (EU-wide) regime for alternative investment funds, where previously regulation had either not existed at all or had focussed on certain activities of certain participants involved in the setting up and running of an alternative investment fund.

5.2 An AIF is very broadly defined in the AIFM Regulations. It includes all alternative investment funds other than UCITS. Therefore, it would include all of the CIVs considered in the Table, save for an OEIC established as a UCITS fund and a life company fund. The consequences of each of the non-UCITS funds falling within AIFMD's remit are that detailed new regulation of the vehicle, manager and third parties will apply (through FCA's "FUND" sourcebook) with effect from 22 July 2013. It is not possible to evaluate whether the costs associated with the new regime will outweigh those attributable to existing UCITS or life company regimes. The extent to which these new rules may cause significant extra cost will also depend on whether the supporting parties are AIFMD compliant at their own cost or whether AIFMD compliance becomes part of the set up cost of a new CIV.

5.3 There is a pension specific exclusion in recital 8 of AIFMD which provides that it "should not apply to the management of pension funds… [by] local governments and bodies or institutions which manage funds

supporting social security and pension systems…". This means that although AIFMD does not apply to the LGPS funds themselves, it does apply to any CIV which is not a UCITS (and not a unit-linked life fund).

## 6 PROCUREMENT LAW ASPECTS

**Introduction**

6.1 Public procurement of investment-related services will obviously add time and cost to the establishment of any new CIV. For that reason alone it is necessary to assess how the procurement rules apply, let alone the risk of challenge that either the procurement rules have not been applied properly or that they have simply been ignored when they should have been applied. This is a complex area of the law on which Counsel's opinion should be sought.

6.2 The administering authorities of LGPS funds are covered by the Public Contracts Regulations 2006 ("PCR") as contracting authorities. They are therefore subject to EU procurement rules. This means that, unless there is a relevant exemption in the PCR, the appointment of any new investment manager or the entering into a new investment arrangement requires a public procurement exercise to take place in accordance with those rules[8].

**Application to investing in a CIV**

6.3 There is, however, a widely used exemption in Regulation 6(2)(h) of the PCR which provides that, where a contracting authority enters into a contract which is: "for financial services in connection with the issue, purchase, sale or transfer of securities or other financial instruments, in particular transactions by the contracting authorities to raise money or capital", then no public procurement exercise needs to be followed. This exemption merely applies to the direct purchase of investments by a contracting authority, not where a discretionary investment management service is provided.

6.4 The word "securities" is not defined in the PCR, nor is it defined in the European Directive on procurement (2004/18/EC). However, the natural meaning of "securities" when used in other contexts is a wide one and we do not believe that it should be construed narrowly in a technical sense. Hence the fact that a unit trust, for example, does not issue shares, but units, should not be taken to mean that a subscription for units in a unit trust would not fall within the exemption. Shares issued by an OEIC are more obviously to be regarded as securities. Even if the relevant financial services contract is to purchase "other financial instruments", (a phrase which is also not defined) rather than securities, those words should be wide enough to capture unitised investments and would therefore apply to unit trusts as well as unit linked life assurance contracts.

6.5 In principle, we see no reason why this analysis should not also apply to the tax transparent forms of CIV, i.e. the limited partnership and the authorised contractual scheme established on a tenants in common basis. If all the AA is doing is buying an interest in such a CIV, the analysis should be the same as for the other forms of CIV, despite the fact that it is less clear that the limited partnership or ACS either issues or sells "securities" or "other financial instruments".

6.6 It is a completely separate consideration whether, notwithstanding any technical argument that Regulation 6(2)(h) removes the need for a procurement exercise on subscribing for interests in a CIV, it might nonetheless be desirable to do so in the interests of public transparency.

**Services procured by and provided to the CIV**

6.7 The legal structure and ownership of the CIV will determine whether it or its investors (i.e. the administering authorities of LGPS funds) are also involved in procuring additional services which are

**[8] There is a general exemption which applies a de minimis threshold which would be irrelevant in the current circumstances, given the value of potential investments in a new CIV.**

caught by the PCR. As stated above, the PCR only applies to public bodies which are contracting authorities. Therefore, this governance feature of the CIV is extremely important. If the operator of the CIV procures all of the external services and that operator is a private sector body, then the PCR will not apply to it and accordingly the full extent of public procurement rules will also be excluded. However, to the extent that the administering authorities retain control over the provision of services to the CIV via the governance structure of the CIV, there is a clear risk that each of the parties exercising that control will be subject to procurement rules. The services to be procured by a CIV could include those of a discretionary fund manager, the depository (custodian) and the administrator (if that is a different party from the depository), and other advisers such as auditors.

**Governance/ownership issues**

6.8 There is one other consequential issue which relates to the governance structure and who provides services to the CIV. This concerns the ability to apply "internal" or "in house" procurement exemptions, which derive a line of European Court judgements beginning with the Teckal case. This is a growing and developing area of the law which may also be affected by the new European Directive on procurement which is due to come into force in 2014. Without further understanding of exactly how a CIV might be established and the degree to which any private sector party might play a role in that structure is impossible to comment on the application of any such exemption, but a further analysis of the procurement implications may be necessary in due course.

## 7 STATE AID / EU LAW

**State aid**

7.1 Article 107 (1) of the Treaty on the Functioning of the European Union ("**TFEU**") establishes a general prohibition on State aid within the EU. A State measure will constitute State aid, and will in principle be prohibited, if it satisfies all four of the following criteria:

(i) The aid is granted by a Member State or through State resources;

(ii) The aid confers an advantage on the recipient by favouring certain undertakings or the production of certain goods;

(iii) The aid distorts or threatens to distort competition; and

(iv) The aid affects trade between Member States.

The four criteria are cumulative, i.e., all four must be met for the measure to constitute State aid. In the absence of any one of them, the measure is not classified as State aid pursuant to Article 107(1) TFEU.

7.2 Investment in the CIVs can therefore not give rise to State aid in the absence of an element of selectivity, i.e., the grant of a selective advantage within the meaning of the second limb of the State aid test (above). In addition, any selective advantage that could be identified would also have to be capable of distorting competition. In the scenarios envisaged, it is unclear whether any actual or potential competition in the market could be distorted. This would depend on the choice of an ultimate CIV model or models.

**Fundamental principles of EU law**

7.3 The implementation of Options 1 or 2 must not infringe fundamental principles of EU law, including in particular the prohibition on discrimination (Article 18 TFEU) and the free movement of goods, services, persons and capital within the internal market of the European Union (Article 26 (2) TFEU). Further detailed analysis may be required in order to ensure that the use of CIVs in practice does not give rise to potential claims that non-UK investment vehicles are suffering discrimination or exclusion in breach of these principles.

## Annex: Detailed Comparison of CIVs

**Note: Please see Executive Summary for an explanation of why we have concluded that the Qualified Investor Schemes (QIS) model would be the optimum vehicle for each of the UT and ACS models, whether established (on an LP or tenants in common basis).**

| Criterion/Feature | UT (QIS) | OEIC | LP (includes LP ACS) (QIS) | ACS (tenants in common) (QIS) | Unit Linked Life Fund |
|---|---|---|---|---|---|
| **Nature of Legal Structure**<br>(relevant to features such as ownership of assets, who contracts on behalf of CIV, who is able to sue/be sued) | Trust established by trust deed, entered into by the manager and the trustee.<br>Established under trust law. | Corporate established by instrument of incorporation under the OEIC Regulations. | Partnership deed established under Limited Partnerships Act 1907 and COLL. | Contractual Scheme established by deed and COLL. | Corporate under Companies Act 2006 or alternative mutual structures. |
| **Ownership of Assets** | Assets owned by trustee. Investors have beneficial interest as unitholders.<br>Trustee contracts on behalf of unitholders. | Assets owned by depositary. Investors are shareholders.<br>ACD as director of OEIC enters into contracts. | Assets held by depositary.<br>Investors are limited partners acting through general partner (GP) as legal owners.<br>NB - Investors lose limited liability if they become involved in management. | Assets held by depositary; beneficially by investors as tenants in common. | Insurer is legal and beneficial owner of property and contracts with third parties.<br>Investors have contractual rights as policyholders. |

| Criterion/Feature | UT (QIS) | OEIC | LP (includes LP ACS) (QIS) | ACS (tenants in common) (QIS) | Unit Linked Life Fund |
|---|---|---|---|---|---|
| **AUTHORISATION ISSUES** | | | | | |
| **Collective Investment Scheme for FSMA purposes?** | Yes | Yes | Yes | Yes | No |
| **Which parties require authorisation by FCA?** | Manager<br>Trustee | Manager/ACD<br>Depositary | Operator/Manager<br>Depositary | Operator/Manager<br>Depositary | Insurer (may delegate to separately authorised Manager). |
| **Threshold conditions requirement for authorisation of Manager/Operator by FCA?** | COND 2: Location of offices, effective supervision, appropriate resources, suitability, adequate business model | As UT | As UT | As UT | As UT, but additional life company authorisation rules apply. |
| **Required personnel/ controlled functions for Manager/Operator.** | Personnel performing controlled functions (e.g. director, investment manager, compliance officer, money laundering reporting officer) must be fit and proper (includes financial solvency, honesty and | As UT | As UT | As UT | As UT, although insurance company personnel will have different skill set requirements. |

| Criterion/Feature | UT (QIS) | OEIC | LP (includes LP ACS) (QIS) | ACS (tenants in common) (QIS) | Unit Linked Life Fund |
|---|---|---|---|---|---|
| | competence/ capability). Personnel to be in place on authorisation. Significant requirements on competence from regulators where advising / managing activities undertaken (effectively degree level plus ongoing CPD requirements). | | | | |
| **Does CIV (and any sub-fund) require authorisation?** | No | Yes | Yes | Yes | Only at insurance company level but substantial regulatory oversight and attention (e.g. see TR13/8 thematic review by FCA into governance of unit linked funds). |
| **Other authorisation features** | | Depositary must be independent of the OEIC (and the ACD). | Depositary must be independent of the Manager. | Depositary must be independent of the Manager. | Full regulatory oversight of capital, systems and controls and conduct of business. |

| Criterion/Feature | UT (QIS) | OEIC | LP (includes LP ACS) (QIS) | ACS (tenants in common) (QIS) | Unit Linked Life Fund |
|---|---|---|---|---|---|
| **Timescales for CIV authorisation**<br>NB need to factor in time to recruit staff with appropriate qualifications for all CIVs if starting from scratch | Timescales extended depending on nature of QIS – can be 3-4 months. | As UT<br>NB ACD authorisation likely to take longer as specific roles and responsibilities under COLL and OEIC regulations require specific expertise. | As UT | As UT | 6 to 12 months from submission of completed FCA application pack, considerable preparation time, so 12-18 months in total. |
| **Timescale for sub-fund from authorisation** | 4-6 weeks | As UT | N/A. No sub-fund permissible – need separate LP | As UT | N/A. In practice sub-funds operate at an accounting level only by the insurer creating separate sections of their pension fund management business. |
| **Capital requirements for establishment?** | **AIFM:**<br>• Initial capital of at least Eur 125k; and<br>• If value of assets under management greater than Eur 250m then additional own funds requirement equalto 0.02% of the excess over Eur 250m | **UCITS/NURS:**<br>• Initial capital of at least Eur 50k/125k (if holding client money) or<br>• Credit risk plus market risk calculation<br>• Fixed overheads | As UT | As UT | Capital resources requirement made up of:<br>• base capital requirement (between Eur 700k and Eur 3.7m)<br>• risk-based capital requirements based on credit |

| Criterion/Feature | UT (QIS) | OEIC | LP (includes LP ACS) (QIS) | ACS (tenants in common) (QIS) | Unit Linked Life Fund |
| --- | --- | --- | --- | --- | --- |
| | (subject to a Eur 10m cap)<br>• Own funds must not be less than 25% of annual expenditure<br>• Own funds may be reduced by bank guarantee or PI insurance in certain cases. | 25% relevant annual expenditure | | | risk, market risk, liquidity risk, operational risk and insurance liability risk |
| **INSOLVENCY ISSUES** | | | | | |
| **Segregation of sub-funds' liabilities?** | Umbrella schemes possible but not legally segregated at sub-fund level protection. | Protected cell regime provides that individual sub- funds can be legally segregated and protected from other sub-funds. | Not possible to have umbrella schemes, so no sub-funds segregation. | Umbrella schemes with sub-funds possible (see OEIC comments). | Segregation achieved at accounting level only. |
| **Rights on Insolvency of CIV** | Unsecured creditor | Unsecured creditor | Unsecured creditor (of underlying assets). | Unsecured creditor (of underlying assets). | Special creditor regime under Insurance Insolvency Directive gives policyholder preference over unsecured creditors. |

| INVESTMENT RESTRICTIONS | | | | | |
|---|---|---|---|---|---|
| **Investment restrictions on the vehicle?**<br><br>**NB: Table contains a summary of the most relevant and important limitations for authorised CIVs (OEIC and life fund).** | There is a basic requirement for a spread of risk consistent with the investment objective and policy but there are no specific spread or concentration limits, except in relation to property.<br><br>The following are permitted investments for a QIS:<br>• Shares.<br>• Debt instruments.<br>• Deposits.<br>• CISs.<br>• Derivatives.<br>• Contracts of insurance.<br>• Government and public securities.<br>• Property.<br>• Precious metals (gold, silver and platinum).<br>• Commodity contracts. | UCITS:<br>• May invest no more than 10% of its assets in transferable securities or approved money-market instruments which are issued by any single body and all holdings in excess of 5% of its assets may not, in aggregate, exceed 40% of the assets.<br>• No more than 20% of scheme property may be in transferable securities or approved money-market instruments issued by entities in the same group.<br>• No more than 20% of assets may be invested in any one single CIS (UCITS or non-UCITS), with a general restriction of a maximum of 30% of assets invested in non-UCITS schemes. | As UT | As UT | Permitted links rules apply:<br>• Must have in place appropriate valuation procedures<br>• Permitted links must be via approved indices only<br><br>Permitted links include:<br>• Approved securities<br>• Listed securities<br>• permitted unlisted securities<br>• permitted land and property<br>• permitted loans<br>• permitted deposits<br>• permitted scheme interests<br>• cash<br>• permitted units<br>• permitted stock lending<br>• permitted derivatives |

| | | | | | |
|---|---|---|---|---|---|
| | | • Maximum OTC derivatives, counterparty exposure is limited to 5% (10% in the case of approved banks).<br>• No more than 20% of assets may be invested in a combination of transferable securities and approved money-market instruments issued by, and deposits or OTC derivative transactions made with, a single body.<br>• No more than 35% of assets may be invested in the government or public securities of a single body (subject to the point below).<br>• Over 35% of scheme property may be invested in a single government or public securities body, but there is a restriction that no more than 30% of | | | Note: the terms above have specific meaning in the FCA glossary. The detailed rules are designed to protect policyholders. |

| | | | | | |
|---|---|---|---|---|---|
| | | the scheme property consists of securities of any single issuer and a requirement that the securities must come from at least six different issuers | | | |
| **VALUATION ISSUES** | | | | | |
| **Valuation rules for investor interests specified by FCA?** | • The manager should exercise due diligence in connection with valuation and pricing, and show that it has complied with the minimum control requirements set out in the FCA rules.<br>• The Manager has a duty to ensure that prices used to value investments are correct and to take action to rectify any incorrect (including reimbursing or compensating investors). | • See UT for valuation rules for specified investor interests.<br>• Under the FCA rules, there is a set of minimum checks that a depositary must perform to satisfy itself that the ACD's pricing operation is adequately controlled and the risk of incorrect prices is minimised. | As UT | As UT | Specific insurance company rules relating to valuation of assets. |

| **Valuation and Pricing of Assets** | AIFM: at NAV<br>Dual or single pricing<br>Forward or historic pricing | At NAV<br>Dual or single pricing<br>Forward or historic pricing | At NAV<br>Dual or single pricing<br>Forward or historic pricing | At NAV<br>Dual or single pricing<br>Forward or historic pricing | At NAV<br>Varied practices, including Forward or Historic pricing and priced on Dual or single basis<br>FCA TR13/8 comments on pricing and valuation practices in unit-linked funds. |
|---|---|---|---|---|---|
| **GOVERNANCE** | | | | | |
| **Governance**<br>Disclosure and reporting requirements | • Legal and regulatory reporting requirements.<br>• A prospectus – must comply with COLL content requirements.<br>• AFM must publish the annual reports and accounts within four months of the end of the fund's annual accounting period and the interim, or half-yearly, report and accounts within two months of the interim accounting date. | • Changes to funds subject to COLL rules which determine how changes should be treated, and as a consequence, whether they require approval of FCA, unit holders or notifications.<br>• Materiality of their impact will determine whether the change is to be treated as a pre- or post-notifiable, significant (pre-event notification) or fundamental (shareholder vote) | As UT | As UT | PRA / FCA oversight of governance regime.<br>Substantial PRA reporting and preparation of ongoing capital, solvency, investment and general corporate governance. |

| | | | | | |
|---|---|---|---|---|---|
| | • Long and short form report requirements<br>• Changes to funds subject to COLL rules which determine how changes should be treated, and as a consequence, whether they require approval of FCA, unit holders or notifications.<br>• Materiality of impact will determine whether the change is to be treated as a pre- or post-notifiable, significant (pre-event notification) or fundamental (shareholder vote) change.<br>• Regime for merger and winding-up subject to regulator consent | change. | | | |
| **TAX ISSUES** | | | | | |
| **VAT**<br>Fund management charges | VAT exemption for management fees. | VAT exempt for management fees. | VAT exemption for management fees. | VAT exemption for management fees. | VAT exempt. |

| | | | | | |
|---|---|---|---|---|---|
| **Stamp Duty/SDRT on unit/interest/share purchases** | Schedule 19 Finance Act 1999 imposes a stamp duty reserve tax; - the tax is charged on surrenders of a unit in an AUT to the manager.<br><br>Schedule 19 is to be abolished by the Finance Bill 2014 and the tax will be payable until then. | See UT | The Stamp Duty and Stamp Duty Reserve Tax (Collective Investment Schemes) (Exemptions) Regulations 2013 provides specific exemptions from Stamp Duty and SDRT for transfer units within an ACS and transfers of securities to an ACS. | As ACS LP. | No SDRT or stamp duty on life funds – no change in beneficial ownership. |
| **Withholding tax at CIV level on overseas securities**<br><br>**NB Detailed analysis will depend on double-tax treaties to mitigate withholding taxes.** | The UT may be subject to non UK withholding tax on its investments in non UK equities and debt securities. | As UT<br><br>OEIC is beneficial owner hence similar to life company and may be able to rely on double-tax treaties. | Tax transparent so should be able to rely on treaty relief, but will depend on recognition of vehicle's tax transparency. | Tax transparent so should be able to rely on treaty relief, but will depend on recognition of vehicle's tax transparency. | Life company as beneficial owner may be able to rely on some quite long standing double-tax treaties. |

# Appendix 6b Legal issues – option 3 Squire Sanders

## 1 INTRODUCTION/SCOPE

1.1 This section of our report identifies actual and potential barriers to merging LGPS Funds and to consider ways in which those barriers might be overcome. This analysis necessarily involves detailed construction of statutory language and therefore statutory powers. It should also be noted that the legislation governing the LGPS was not drafted with the original intention of facilitating a merger of funds so the construction of the language used needs also to be overlaid with an understanding of what the aim of Parliament was in agreeing on particular terminology in the way that it has.

1.2 Where we have concluded that additional primary legislation may or may not be required, that conclusion is necessarily based on our interpretation of statute, but our views could be challenged by other stakeholders. To add weight to the more complex areas of analysis we strongly recommend engaging leading Counsel to confirm our conclusions.

1.3 The mechanics of any merger of pension funds is a complex matter. However, the key dependencies are simply whether assets and liabilities can be transferred effectively, with the result that members' entitlements are kept whole and that there is a clear allocation of responsibilities before and, more importantly perhaps, after the merger. In the context of the LGPS where there is a complex inter-relationship between the roles of the Secretary of State, the administering authorities ("AA"), scheme employers, scheme members (to say nothing of third parties), these dependencies have many different aspects. The table in section [3] below summarises these dependencies but must be read in conjunction with the detailed commentary in section 4 below.

1.4 **Glossary of defined terms**

"AA" means Administering Authority

"Investment Regulations" means the Local Government (Management and Investment of Funds) Regulations 2009 (as amended)

"1972 Act" means the Superannuation Act 1972

"2008 Regulations" means the Local Government Pension Scheme (Administration) 2008 Regulations

"2013 Act" means the Public Service Pensions Act 2013

"2013 Regulations" means the Local Government Pension Scheme Regulations 2013

## 2 SUMMARY OF RESEARCH APPROACH

2.1 In order to establish whether the legislative framework would enable the Secretary of State to order the transfer of assets and/or liabilities from existing LGPS funds to other vehicles, it is necessary to confirm both the existence and range of the Secretary of State's current powers, as well as how those powers relate to the statutory responsibilities and functions of both administering authorities and scheme employers. In turn, this requires consideration of primary legislation covering both the existing LGPS benefit structure and that which will apply from April 2014 for each of these parties.

2.2 A variety of different business models could be used as the receiving entity for a fully merged new fund structure, although there are "political" as well as legal drawbacks with using any of the existing LGPS AAs' funds as such a vehicle, given that they were established to cover specific geographical areas (regardless of the political issues associated with local accountability and different funding levels) and

the statutory alignment of funds to AAs is set out in primarily legislation so can only be amended by further primary legislation.

2.3 It is important to distinguish between the terminology here: the body that is responsible for discharging the benefit obligation to the members (i.e. the AA) has a fund" or "funds" which is designed to be sufficient to do so. The AA has an obligation to invest the monies it receives and can do so, subject to the Investment Regulations, in a range of different vehicles or directly. The "fund" is therefore separate from the underlying investment vehicle and is an asset owned by the AA. In turn, the power of investment (and in fact duty to do so) is vested in the AA for its fund; it does not belong to nor is it delegated by the Secretary of State.

2.4 The key issues relate to whether:

(a) the assets supporting current liabilities can be transferred under the control of other AAs or new statutory bodies; and

(b) whether scheme liabilities may be transferred in the same way.

2.5 In turn this leads to the following questions:

(a) does the Secretary of State have the power to compel mergers of assets and liabilities within existing vehicles only or would it be necessary and/or desirable to create new funds and/or AAs?

(b) if the Secretary of State does not have the requisite powers and primary legislation is necessary, is there a suitable precedent that exists?

2.6 It is also necessary to look at other powers than those which govern the mere transfer of assets and liabilities. These include the degree of prescription which applies to current AAs under the existing LGPS and how scheme employers are mandated to adhere to a particular one of the 89 current LGPS Funds.

2.7 If the Secretary of State does possess the above powers already, or can reserve them to himself by means of making new regulations made under existing primary legislation, the next level of analysis is whether third parties, whose rights and obligations are not expressly covered under the statutory framework, can also have their obligations and rights transferred or assigned to apply to a new structure. We consider each of those issues in turn.

## 3 SUMMARY OF LEGAL DEPENDENCIES

| Pre-condition to merger of funds | Pre-2014 legislative power (Primary or Secondary) | Post-2014 legislative power (Primary or Secondary) | Potential Legislative solution |
|---|---|---|---|
| Establishment of new Fund and new Authority | N/A | Section 3(1), 2013 Act | Regulations |
| Alignment of statutory functions of Act and requirement to maintain a fund | The "Appropriate Fund" is designated by Regulation 29 and Schedule 4 of the 2008 Regulations | Regulation 53 and Schedule 3 of the 2013 Regulations identify the bodies who are required to maintain a pension fund and are therefore AAs | Regulations - would be required to amend these provisions if the AAs were to change. |
| Allocation of employers to the new fund | The "Appropriate Fund" is designated by Regulation 29 and Schedule 4 of the 2008 Regulations | Scheme employers are designated by Part 2 of Schedule 4 of 2013 Regulations | Regulations -would be required to amend these provisions if scheme employers were reallocated. |
| Transfer of existing fund (assets only) to new Authority | "Amalgamation" under Schedule 3, (Para 2) 1972 Act | Section 3(1), 2013 Act and Schedule 3<br>Broad power to make regulations in relation to schemes - not specific | Regulations |
| Transfer of past liabilities to the new Authority | "Amalgamation" under Schedule 3, (Para 2) 1972 Act | Schedule 3, paragraphs 11 and 12 of the 2013 Act permits regulations for administration, management and winding up and for nominating who must provide benefits. | TBC. Regulations may be made by the Secretary of State |
| Novating existing admission agreements and supplier contracts (these will include the current AA as a party) | N/A [*Existing Admission Agreements saved by Transitional Regulations*] | Section 3(2) 2013 Act consequential etc power, may be sufficient. | Regulations would be needed to novate all admission agreements wholesale and any supplier contracts to the new fund. |

## 4 POWERS TO FACILITATE THE MERGER OF LOCAL GOVERNMENT PENSION FUNDS

4.1 The 1972 Act gives the Secretary of State the power to make regulations to provide pension arrangements for persons employed in local government service. Regulations were subsequently made to confirm the then applicable and subsequent benefit structures.

4.2 The 2013 Act (which applies to all public service pension funds, not just the LGPS) changed the benefit structure for the LGPS from 1 April 2014 and created new powers in respect of contributions from scheme employers and employees, albeit that those funding powers largely replicated the 1972 Act powers.

4.3 It should be noted that the investment powers of the LGPS funds have not been changed by the 2013 Act, so the only powers and duties AAs have are given under the 1972 Act.

4.4 This means that there is no pre and post 2014 distinction between the funds held by the AA and the benefit obligations due to the members. Where an AA decides to use its statutory powers to establish a separate fund for particular employers by virtue of Regulation 32 of the 2008 Regulations and/or Regulation 54 of the 2013 Regulations, it is within the AA's discretion to do so. This is the only mechanism by which liabilities for particular employers are separately identified and hypothecated. The legislation does not operate so as to ringfence the affected members' rights to benefits[9].

4.5 This principle is reinforced by the language of Regulation 86 of the 2008 Regulations (mirrored in Regulation 103 of the 2013 Regulations) which makes it very clear that any given member is to be identified, for funding purposes, as having an "appropriate fund".

4.6 A further nuance of this lack of correlation between a member's benefits and funding is that while the benefits are effectively guaranteed at the level of the LGPS as a whole, the rights of the member can only be asserted against the responsible AA for the relevant fund. For example, a member who paid contributions to a London borough fund cannot bring a claim against a metropolitan AA (and nor can the London borough fund itself). As evidence of this principle see Regulation 96 of the 2013 Regulations ("*the relevant transfer (to another scheme) may only be paid by the administering authority from its pension fund*"). This issue was examined in a judicial review brought by South Tyneside Metropolitan Borough Council where it was held that liability of the employer to contribute to a deficit in the Northumbria CC Pension Fund had not been transferred as a result of a restructuring (see further below).

1972 Act powers: detailed analysis

4.7 The general power to establish superannuation schemes for employees in local government service is set out in section 7 of the 1972 Act in the following terms:

*"The Secretary of State may by regulations make provision with respect to the pensions, allowances or gratuities which, subject to the fulfilment of such requirements and conditions as may be prescribed by the regulations, are to be, or may be, paid to or in respect of such persons, or classes of persons, as may be so prescribed"*

This power does not appear to place any limits on the scope of regulations that may be made under the Section 7 power. In fact, virtually all of the secondary legislation passed for the purposes of the reorganisation examples we cite below, was made under this Section.

4.8 Notwithstanding the power in Section 7, Schedule 3 of the 1972 Act details the specific provisions which may be included in regulations for local government pension arrangements.

(a) Paragraph 2 of Schedule 3 provides that:

*"Regulations may [provide] for the establishment and administration of superannuation funds, the management and application of the assets of such funds, the amalgamation of all or any of such funds, and the winding-up, or other dealing with, any such fund."*

The terms "amalgamation" and "winding-up" are not defined in the 1972 Act and do not appear to have been considered further by the Courts in this context, nor has the definition been clarified in other legislation. Consequently, we have to apply an ordinary construction to those words. The word "fund" is not defined and would, we suggest, normally refer to the assets only of the relevant arrangement, without including the concept of the liabilities. This is a vital point

[9] **As an aside, members' rights to benefits are not hypothecated by reference to particular assets(with the exception of AVCs) although even where, legally, any money purchase AVCs will be held in the name of the AA, not the member.**

of construction and is not free from doubt. However, because benefits are guaranteed and not dependent on a given level of funding, there is no reason to suggest otherwise.

"Amalgamation" would suggest the merger of such funds, and "winding-up" would, in our view, generally imply termination of a fund. Whether such a winding up would necessarily include a discharge of liabilities is not clear from the context. We would suggest, for the reasons given above that there would have been no need to specify that a discharge of liabilities would necessarily follow on the exercise of the power, given that, again, from the member's point of view, the benefits are guaranteed.

Notwithstanding this uncertainty, the specific enabling power in paragraph 2 of Schedule 3 is also very broad, particularly in the phrase "or other dealing with" which would imply any other action the Secretary of State may wish to take, subject to the general principles that statutory functions and discretions can only be exercised within the judicial test colloquially known as "Wednesbury reasonableness", established in Associated Provincial Picture Houses Ltd v Wednesbury Corporation [1948]. In that case the judge held that "*if a decision on a competent matter is so unreasonable that no reasonable authority could ever have come to it, then the courts can interfere.*"

(b) Paragraph 3 of Schedule 3 specifies provisions relating to the transfer of benefits:

> *"Regulations may [provide] for the payment and receipt of transfer values or in lieu thereof for the transfer or receipt of any fund or part of a fund or policy of insurance".*

We understand the reference to the payment of transfer values here to apply to individual members although there is nothing to prevent that power applying on a bulk basis. Both assets and liabilities can therefore be transferred under this power, but, when read in conjunction with the powers above, it does not seem to add anything that is not already covered.

4.9 Finally, Schedule 3 also contains a general provision (under paragraph 13) to allow the Secretary of State to make "such incidental, supplementary, consequential and transitional provisions as appear to the Secretary of State to be necessary or expedient". However, this would be restricted by the scope of the original powers under the 1972 Act . As established by similar wording in s.111 of the Local Government Act 1972 (which has been the subject of detailed judicial authority in a line of cases on vires issues), a public body can only exercise powers that are within the framework of being incidental etc to the original power and not for some completely different purpose.

Conclusion

4.10 From the analysis above, we believe that there is a clear statutory power to amalgamate funds (i.e. assets only). We do not believe there is such a clear power to transfer liabilities without looking at the way that those liabilities attach to AAs and/or scheme employers, as to which see below.

Future regime (post 2013 Act)

4.11 We now need to examine the different ways in which the 2013 Act and the 2013 Regulations deal with these powers.

4.12 Section 1 of the 2013 Act provides a power to make "scheme regulations" to establish schemes for payment of pensions and other benefits for local government workers.

4.13 It is interesting to note the use of the word "scheme" and the word "fund" in the 2013 Act, a complexity that is not present in the 1972 Act (which uses the word "fund" throughout).

"Scheme" is defined in the 2013 Act as meaning "*includes arrangements of any description*". In context, therefore, this would not necessarily be limited to new pension schemes (which would be "new public body pension schemes" covered by section 30). It is clear elsewhere that such an arrangement can be connected with another scheme (see section 4(6)). The term "scheme" is widely used in the 2013 Act. In general it can be taken as referring to the new benefit structures established under existing public sector pension arrangements.

It appears that the 2013 Act uses the word "fund" (although it is not defined) to refer to the assets supporting the "scheme".

4.14 From 31 March 2014 no further benefits can be provided under the existing regulations relating to the LGPS made under the 1972 Act except where the benefits can also be provided under the provisions of the 2013 Act (Section 18). However, to that extent, existing LGPS funds are treated as if they had been established under the 2013 Act (see Section 28(3)). In essence, Section 28 creates a bridging power to link pre 2014 and post 2014 LGPS benefits. However we note that section 28(2) preserves regulations made under section 7 of the 1972 Act:

"*to the extent that:*

(a) *such regulations make <u>provision for the payment of pensions and other benefits</u> [for post 1 April 2014 Service], <u>and</u>*

(b) *that provision could be made under scheme regulations."* [emphasis added].

4.15 This power is restricted in its scope to regulations which are for the purpose of "payment of pensions and other benefits", which would not encompass a power to amalgamate funds nor alter the Investment Regulations.

4.16 Section 3 provides for a broad power for regulations to be made by the Secretary of State(as the "responsible authority" under Schedule 2) in relation to schemes under the 2013 Act:

*"3 Scheme regulations*

*(1) Scheme regulations may, subject to this Act, make such provision in relation to a scheme under section 1 as the responsible authority considers appropriate.*

*(2) That includes in particular-*
- *(a) provision as to any of the matters specified in Schedule 3;*
- *(b) consequential, supplementary, incidental or transitional provision in relation to the scheme or any provision of this Act.*

*(3) Scheme regulations may-*
- *(a) make different provision for different purposes or cases (including different provision for different descriptions of persons);*
- *(b) make retrospective provision (but see section 23);*
- *(c) allow any person to exercise a discretion.*

*(4) The consequential provision referred to in subsection (2)(b) includes consequential provision amending any primary legislation passed before or in the same session as this Act (as well as consequential provision amending any secondary legislation).*

*(5) Scheme regulations require the consent of the Treasury before being made, unless one of the following exceptions applies.*

*(6) The exceptions are-*
- *(a) scheme regulations of the Scottish Ministers relating to local government workers, fire and rescue workers and members of a police force;*
- *(b) scheme regulations of the Welsh Ministers relating to fire and rescue workers."*

4.17 On the face of it, this gives the Secretary of State very broad powers to legislate for anything connected to the LGPS, albeit subject to the 2013 Act. The general rules discussed in section 4.8 above about the reasonableness of the Secretary of State's decision-making powers would therefore also apply. The

Explanatory Notes to the Act give examples of what is meant by the limits prescribed by the phrase "subject to this Act", eg the scheme manager provisions in section 4.

4.18 Construing the rest of the language in Section 3 of Schedule 2 and the scope of the Secretary of State's powers is complex because of the following factors.

(a) The list of matters in Schedule 3, in Section 3(2)(a) which, as noted above, includes no reference to merger or amalgamation, is prefaced by the non-exhaustive words "in particular". The Explanatory Notes (para 20) reinforce this point: "If a matter is not mentioned in Schedule 3 this does not prevent it from forming part of such a scheme, provided it is within the powers given by sections 1(1) and 3(1)". (emphasis added albeit this is merely a note, not the statute itself) .

(b) The terminology in sub-Section 3(3) is also clearly very broad. The Explanatory Notes (para 22) are less helpful here: "This is a common provision in regulation-making powers to ensure that they are appropriately flexible." Of itself, however, the "purposes" or "cases" must still be referable to the scheme as envisaged by section 1.

(c) Finally, para 24 comments on the references to the "consequential provision" in Section 3(4): "only primary legislation passed before or in the same parliamentary session[10] as this Act can be amended. This power may be necessary where legislation is inconsistent with or requires modification as a consequence of scheme regulations or a provision of this Act. Section 24(1)(a) further requires that any amendment to primary legislation must be made by the affirmative procedure. The meaning of "affirmative procedure" is given in section 38(2)", which essentially says that any regulations have to be laid before both Houses of Parliament and approved by both Houses.

4.19 Taking all of these points together, there is a multiple test to establish whether "scheme regulations" can or cannot be made within the ambit of Section 3:

(a) they must be "appropriate" for the Secretary of State, acting reasonably, to make in relation to the LGPS;

(b) the list of matters in Schedule 3 is non-exhaustive and scheme regulations may be made for "different purposes or cases", but again must in some way attach to the LGPS as a scheme; and

(c) if a consequential provision is encapsulated within a regulation made under Section 3, it can only be passed by the affirmative resolution procedure, i.e. by both Houses of Parliament.

4.20 Applying these principles to the Act as drafted, the following conclusions can be reached. Section 3(2)(a) provides that regulations may be made in relation to the matters set out in Schedule 3. The provisions relevant to a transfer of benefits and the potential merger of funds are as follows.

(a) *"The payment or receipt of transfer values or other lump sum payments for the purpose of creating or restoring rights to benefits (under the scheme or otherwise)"* (paragraph 10 – emphasis added).

(b) *"Pension funds (for schemes that have them). This includes the administration, management and winding-up of any pension funds" (*paragraph 11 – emphasis added*).*

[10] **This is an annual period running from the first Thursday of May, the 2013 Act received Royal Assent on 25 April 2013 so the relevant session has now apparently passed.**

4.21 There is therefore no equivalent specific power under the 2013 Act allowing regulations to be made for the "amalgamation" of pension funds as under paragraph 2 of Schedule 3 of the 1972 Act. Notwithstanding this lack of a reference, we need to confirm whether the very broad power under Section 3 is sufficient to allow for amalgamation of funds, given the hurdles set out above. It is certainly odd that the wording was not carried over from the 1972 Act.

4.22 A contrary argument to the lack of an express reference to the power to amalgamate funds can be found in the wording of paragraph 11 to Schedule 3 of the 2013 Act. That paragraph, as quoted above, includes the words "*This includes*". Applying a general principle of construction, this would suggest that the activities which can be made the subject of regulations under Schedule 3 paragraph 11 is not exclusive and it might be argued that the amalgamation and merger of pension funds is necessarily to be implied in the phrase "*administration, management and winding-up*". We would recommend seeking Counsel's opinion on this argument.

4.23 We now need to consider whether the power to make regulations governing LGPS Funds themselves and the appointment of AAs could be used to transfer both the assets and the liabilities on an amalgamation (if that power could be exercised under regulations made under section 3(1)). Clearly, the assets of a particular LGPS Fund, on a merger or amalgamation, would then become assets of the new merged entity.

## 5 POWER TO SUBSTITUTE ADMINISTERING AUTHORITIES

5.1 The provisions relevant to the admission of "participants" (i.e. employers) into the LGPS are currently found in part 4 of the 2008 Regulations. There are two broad groups of participants (termed "employing authorities") whose employees may join the LGPS: Scheme Employers and Admission Bodies.

5.2 In each case the 2008 Regulations dictate the "appropriate fund" that the employees of each employing authority will be eligible to join (see below). The 2013 Regulations provide for a similar mechanism at Part 2 of Schedule 3.

5.3 Schedule 4, part 1 of the 2008 Regulations sets out a table of appropriate authorities. However, broadly:

(a) employees of an AA are members of the fund maintained by that authority;

(b) employees of an admission body are members of the AA's fund with which the admission body entered into an admission agreement; and

(c) where an authority does not have its own fund, the 2008 Regulations refer back to the Local Government Pension Scheme Regulations 1997 which, at Part 3 of Schedule 5, contains a list of authorities participating in other funds.

5.4 Schedule 2 of the 2013 Regulations contains the corresponding list of AAs to the 2008 Regulations. In order to sever the linkage between scheme employers and the appropriate AA that would necessarily happen on a merger, it would be necessary to amend these provisions to allocate an alternative fund to each scheme employer. Such an amendment could be made by "consequential" regulations under section 3(2)(b), which, as noted above, brings into play the affirmative procedure.

5.5 Schedule 4 of the 2008 Regulations further states that where an employing authority "merges or amalgamates" with another employing authority, or the members would be required to contribute to more than one fund, then the employing authority can make an application to the Secretary of State to direct to substitute the fund to which its employees are allocated. Note that it is the employing authority which must merge or amalgamate, not the fund itself, to trigger such a reorganisation.

Before making such a direction, the Secretary of State must consult with any affected bodies, but ultimately may:

*"…require the making of financial adjustments between the funds, whether by way of payment to the substituted fund or a transfer of assets or both.*

*It may also contain provision as to the transfer of liabilities to the substituted fund, may require a revised rates and adjustment certificate in respect of each employing authority concerned, to take account of the effect of the direction and may make provision for any other consequential or incidental matters."*

5.6 Consequently, since an "employing authority" is defined as "a body employing an employee who is eligible to be a member" any scheme employer or admitted body can make an application to the Secretary of State for a direction to substitute the fund in relation to its participation in the LGPS.

5.7 The power is dependent on each AA making an appropriate application and is not within the gift of the Secretary of State. Further, although these legislative provisions apply directly to substitute any fund applicable to a scheme employer or admission body, there is no specific provision for an automatic substitution of AA for the purposes of an admission agreement. Consequently, the admission body would have to enter into a new admission agreement with the new relevant AA on each substitution of fund.

5.8 Schedule 3 of the 2013 Regulations contain comparable but not precisely the same powers in relation to transfers. The relevant powers of the Secretary of State have been simplified in the language but again operate on application by the scheme employer, not as a reserved power:

"*3 The Secretary of State may, on application by a Scheme employer, by a written direction substitute a different administering authority as the appropriate administering authority for a person or class of person.*

*4 A direction under paragraph 3-*

*(a) may only be given after the Secretary of State has consulted any bodies appearing to be affected by a proposed direction, and*

*(b) may include provision as to the making of adjustments between funds, the transfer of assets and liabilities, and any other consequential or incidental matters."*

Note that, in order for these powers to be used, the Secretary of State must consult with the "bodies" affected by the proposed transfer.

Further on in Schedule 3, under paragraph 12, there is scope for regulations to be made in relation to:

"*The administration and management of the scheme, including –*

*(a) the giving of guidance or directions by the responsible authority to the scheme manager (where those persons are different);*

*(b) the person by whom benefits under the scheme are to be provided;*

*(c) the provision or publication of the information about the Scheme.*" (Emphasis added)

From the above, it will be seen that paragraph 12(b) does allow the Secretary of State to make regulations in relation to changing an AA, given that that is the "*person by whom benefits...are to be provided*".

Transfer of statutory functions of current AAs to new bodies

5.9 In order to implement and administer a merger of funds successfully it would be necessary to transfer certain powers, including the administration and investment powers, from the current AAs to new AAs or to create one or more separate bodies to exercise those powers. In the past, this has always been done by primary legislation (see Section 7 below). No doubt that was because other non-pension powers were being transferred also.

It may be, if the conclusion is reached that the powers in Section 3 and Schedule 3 are broad enough, secondary legislation could be provided to achieve the same result.

5.10 Whichever route might be adopted, care would need to be taken if any transfers of funds and liabilities were to be made, in light of the South Tyneside[11] case.

5.11 In the South Tyneside case certain committees of five magistrates' courts were abolished and the liabilities transferred to a new body, after certain court reforms, the Lord Chancellor became successor to those liabilities. Despite the transfer, the Lord Chancellor refused to fund a deficit relating to former employees of the abolished magistrate's court committees. The Court of Appeal found that, on proper construction of the LGPS regulations then in force, there was no obligation on the Lord Chancellor to contribute to the fund in question as the employing authority's employees no longer made contributions to that fund.

5.12 This raises, in particular, the issue that making any transfers without clear legislative authority could have unintended consequences and that, on a transfer, contributions (including deficit payments) from "former" employers that are owed to the current AAs should be addressed before rather than after the event.

## 6 WHAT ARE THE POWERS TO TRANSFER ADMISSION AGREEMENTS AND/OR SUPPLY CONTRACTS?

6.1 One of the potential consequences of Option 3 would be the lack of a contractual relationship between the scheme employers and the relevant new AA that would assume responsibility for administering the merged fund. Existing contractual relationships are evidenced by an admission agreement. The terms of admission agreements are prescribed only as to their minimum content by regulations (Schedule 3 to the 2008 Regulations and Part 3 of Schedule 2 to the 2013 Regulations). These include certain automatic termination events, which are as follows:

(a) if the admission body ceases to be such a body (note that, under paragraph 8 of Schedule 3 of the 2008 Regulations, admission bodies must notify the AA of anything which may be a termination event. This includes a take-over, reconstruction or amalgamation of the employer, liquidation or receivership or a change in the nature of the body's business or constitution).

(b) on three months' notice (paragraph 9 to Schedule 3); and

(c) the parties to the admission agreement may also make such other provision about its termination as they consider appropriate.

**[11] South Tyneside Metropolitan Borough Council, R (on the application of) v The Lord Chancellor and Secretary of State for Justice & Anor EWCA Civ 299**

6.2 The requirements for the terms of an admission agreement do not envisage the possibility of merging funds or the novation/ assignment/transfer of the agreement where one party, the AA, simply disappears. It may be, of course, that individual agreements do cater for such events but in our experience, administering authorities do not draft their admission agreements to cater for anything other than the bare minimum requirements set out in statute.

6.3 Part 3 of Schedule 2 to the 2013 Regulations contains similar provisions at paragraph 9:

"*An admission agreement must include-*

*(a) provision for it to terminate if the admission body ceases to be such a body;*

*(b) a requirement that the admission body notify the administering authority of any matter which may affect its participation in the Scheme;*

*(c) a requirement that the admission body notify the administering authority of any actual or proposed change in its status, including a take-over, reconstruction or amalgamation, insolvency, winding up, receivership or liquidation and a material change to the body's business or constitution;*

*(d) a right for the administering authority to terminate the agreement in the event of:*

*(i) the insolvency, winding up or liquidation of the admission body;*

*(ii) a material breach by the admission body of any of its obligations under the admission agreement or these Regulations which has not been remedied within a reasonable time;*

*(iii) a failure by the admission body to pay any sums due to the fund within a reasonable period after receipt of a notice from the administering authority requiring it to do so*."

It will be noted that, again, there is no provision requiring automatic termination of admission agreements triggered by a merger of LGPS funds.

6.4 There are other provisions of admission agreements which would also need to be novated or assigned to the new AA on a merger under Option 3. These include the requirement for the admission body to pay contributions to the AA, which will be named specifically in the agreement and so will be the "wrong" party.

6.5 Any changes to admission agreements and, more widely, any supply contracts, will need to be made individually to each agreement under its specific amendment terms or by way of overriding legislation. Without an overriding statutory power, such as that used on the reorganisation of Welsh local government in 1995, this would be a very significant undertaking.

## 7 EXAMPLES OF TRANSFER OF OBLIGATIONS AND LIABILITIES OF ADMINISTERING AUTHORITIES

7.1 In this section we briefly examine three precedents for reorganisations of LGPS funds, which each followed on from wider local government changes. In two cases (the GLC and Welsh authorities) primary legislation was used. We have not considered in detail whether it would have been possible to avoid the use of primary legislation, but given the wider ambit of each reform the question may be academic.

7.2 Abolition of the Greater London Council (GLC).

(a) The Local Government Act 1985 (LGA 1985) provided for the abolition of both the GLC and the Metropolitan County Councils, with effect from 1 April 1986. A number of the functions of the GLC were transferred to the London Residuary Body set up for that purpose.

(b) Section 60 of the LGA 1985 provided for the automatic transfer of the GLC's position as an AA to the London Residuary Body. This included, specifically:

(i) functions as an AA under Regulations made under Section 7 of the 1972 Act; and

(ii) all liabilities of the GLC in respect of pensions payable by it or otherwise.

(c) These functions and liabilities were then transferred to the LPFA on the winding up of the London Residuary Body at the end of October 1989.

(d) Since the GLC had a number of statutory functions other than acting as an AA, and Government was also abolishing other Metropolitan County Councils, it is not unexpected to find that Government chose to use primary legislation Act to transfer the AA functions of the GLC.

7.3 Local Government Reorganisation in Wales

(a) The Local Government (Wales) Act 1994 (the 1994 Act) contains, at Section 17, a general provision to transfer the functions of the councils being abolished. It has the effect of amending all legislation that referred to the previous council so that it instead refers to the new principal area (post re-organisation).

(b) The Act does not, however, deal with the specifics of the transfer of LGPS functions. This was enacted by the Local Government Pension Scheme (Local Government Reorganisation in Wales) Regulations 1995, which were made under section 7 of the 1972 Act (and not under the 1994 Act).

(c) These Regulations provide for the wholesale transfer of each previous council's functions and obligations as an AA to the successor authority.

(i) Transfer of functions as AA, along with rights and liabilities:

"*all the functions of a previous fund authority as AA under the principal Regulations then in force shall become functions of the successor authority and the pension fund maintained by the previous fund authority, together with all rights and liabilities in respect of it, shall on that date vest in the successor authority.*"

(ii) Employing authorities and admission bodies' obligations to contribute to that fund are moved:

"*any liability of any body or person to make payments into a pension fund maintained immediately before 1st April 1996 by a previous fund authority shall become a liability to make payments into the pension fund maintained by the successor authority*"

(iii) Contracts in place for the purposes of the pension fund were novated:

"*All contracts, deeds, bonds, agreements and other instruments subsisting in favour of, or against, and all notices in force which were given by or to a previous fund authority (or any other body on their behalf) for the purposes of the pension fund maintained by them shall after 31st March 1996 be of force [sic] in favour of, or against, the successor authority*"

(iv) Admission agreements:

"*Without prejudice to the generality of paragraph (3), any admission agreement in force immediately before 1st April 1996 between a body and a previous fund authority whereby employees of that body were, or could be, admitted to participate in the benefits of a pension fund shall after 31st March 1996, have effect as an agreement under regulation B7 of the principal Regulations between the body and the successor authority*".

(v) The obligation to contribute in respect of previous employees was also moved to the successor authority:

"*Where a person-*

*(a) has ceased to contribute to a pension fund before 1st April 1996; and*

*(b) has not become a contributor to any other fund maintained under the principal Regulations*

*the pension fund maintained by the successor authority for the previous fund authority who maintained that fund until 31st March 1996 shall after that date be deemed to be the fund to which he was last a contributor.*"

7.4 South Yorkshire Pensions Authority

The Residuary Body

(a) The Local Government Reorganisation (Pensions etc) (South Yorkshire) Order 1987 (the "SY Order") was made under powers in section 67(1)(a) of the LGA 1985:

"*The Secretary of State may by order provide for any such transfer or disposal as is mentioned in subsection (1) or (2) above, whether as proposed by the residuary body or otherwise, and for giving effect (with or without modifications) to any scheme submitted to him under subsection (1) above; and, without prejudice to the generality of that power, any such order may contain such supplementary and transitional provisions as the Secretary of State thinks necessary or expedient, including provisions amending any enactment or any instrument made under any enactment or establishing new bodies corporate to receive any functions, property, rights or liabilities transferred by the order.*"

(b) The above power is a general one for the Secretary of State to make orders to implement an arrangement for the wind up of residuary bodies, and transfer of powers to the new authority (this arrangement is referred to in the power as a "*transfer or disposal as is mentioned in subsection (1) or (2) above*"). The residuary body in question was created by the LGA 1985 as a result of the abolition of the Metropolitan County Councils ("MCCs").

(c) These powers are clearly specific to the circumstances provided for by the LGA 1985 (i.e. the abolition of the GLC and the MCCs), which depend on there being a "residuary body" and the

removal or abolition of the powers of that body. However, it provides a precedent for a broad provision in primary legislation to be used to transfer pensions rights and obligations.

(d) As an aside, the Residuary Body was not given fund raising powers in its own right; it was granted the power by Section 74 of the LGA 1985 to make levies on the rating authorities in its areas to "*meet all liabilities falling to be discharged by it*".

Transfer of pension functions

(e) The SY Order established the South Yorkshire Pension Authority as a body corporate specifically to receive "*functions, property, rights and liabilities transferred by this Order*". The SY Order then went on to make the transfer of all the obligations and liabilities of the residual body in relation to pensions (as specified in Schedule 2):

*"(a) the functions of the Residuary Body as [AA] under the Local Government Superannuation Regulations 1986, together with the superannuation fund maintained by the Residuary Body and all property, rights and liabilities in respect of it;*

*(b) the functions, rights and liabilities of the Residuary Body in respect of pensions payable by it otherwise than under those Regulations;*

*(c) without prejudice to the foregoing, the functions, rights and liabilities which are vested in or fall to be discharged by the Residuary Body under or by virtue of section 61 of the 1985 Act (payment of pensions increases); and*

*(d) any moneys or other property forming a fund maintained by the Residuary Body for the purposes of the functions referred to in sub-paragraphs (b) or (c)."*

(f) The SY Order also made provision for the funding of the South Yorkshire Pension Authority. Article 4 provides:

"*The net expenditure of the Authority in any financial year shall be apportioned between the district councils in the county of South Yorkshire in proportion to the population of their districts, as that population is certified for the making of levies with respect to that year under section 74(2) of the 1985 Act (levies by residuary bodies); and the appropriate portions shall be recoverable by the Authority from each of those councils on written demand.*"

## 8 HOW WOULD THE PROPOSAL AFFECT PUBLIC SCHEMES OTHER THAN THE LGPS?

8.1 The proposal to include non-LGPS schemes in any of the three Options under consideration raises completely different and, in our opinion, insuperable problems which cannot be addressed simply by legislative means (whether primary or secondary). The problems relate to the fact that the trustees of each of the schemes under consideration are bound by the powers that are given to them under their respective trust instruments and also by private sector pensions legislation which reserves to those trustees the following key powers, which can only be exercised unilaterally:

(a) the power of investment ; and

(b) the power to transfer assets to another registered pension scheme.

We have not considered any of the trust deeds and rules of the schemes listed in the schedule provided by DCLG and therefore the following analysis draws on general points of principle.

**Investment Powers**

8.2 In relation to the power of investment, section 34(1) of the Pensions Act 1995, which applies to all occupational pension schemes set up under trust, provides that the trustees of such a scheme shall have the powers of an absolute and beneficial owner. Section 34 provides that trustees may delegate decisions about investments and, in fact, they are required to delegate all day to day decisions to an authorised fund manager if they are not authorised under the Financial Services and Markets Act 2000 for the purposes of investment management activity themselves. This points to the fundamental difference between trustees and AAs in the LGPS context, because trustees are deemed to be acting on behalf of other persons (ie the members and, on some analysis, the scheme employer) in managing the investments subject to their trust. AAs, on the other hand, although absolutely entitled to the assets held within their funds, are acting as principals and not engaged in the activity of managing investments for another person.

8.3 Section 35(4) contains an express reference to the freedom of trustees that is encapsulated in section 34, as follows: "neither the trust scheme nor the statement [of investment principles] may impose restrictions (however expressed) on any power to make investments by reference to the consent of the employer."

8.4 In further support of the principle that trustees' powers of investment must be unfettered, there is a body of case law which comments on attempts to restrict or manipulate trustees' investments powers where they are not exercised for the best interests of the beneficiaries of their scheme.

8.5 In conclusion, although it would be possible, subject to the constitutional framework under which a common investment vehicle was established under options 1 and 2, for the trustees of occupational pension schemes to participate in such a vehicle, there is no mechanism by which trustees could be forced to do so. The fact that the trustees of the schemes under question are responsible for discharging liabilities that may in the past have stemmed from public sector schemes does not alter this analysis.

**Merger**

8.6 There are similar considerations relating to the power to merge schemes to those which apply to the powers of investment discussed above. Although there is no statutory framework for limiting or circumscribing the powers of trustees to transfer out assets and liabilities (or to receive them when a merger takes place), the trust deed and rules will contain the relevant powers which have to be relied upon by the trustees of both the receiving and the transferring schemes. Again, there is a considerable body of case law describing how those powers ought to be exercised, but in brief they must be exercised, as with other fiduciary powers, in the best interests of the members of the relevant scheme and not for some ulterior purpose. It is possible under private sector legislation (The Occupational Pension Schemes (Preservation of Benefits) Regulations 1991) for members' benefits to be transferred without their consent, subject to both giving the members one month's notice of a proposed transfer and obtaining a certificate from the transferring scheme actuary that the benefits to be provided by the receiving scheme are "broadly no less favourable" than those to be transferred.

8.7 Funding considerations are also obviously key, as is a consideration of the potential differences in the balance of powers between the trustees and the sponsoring employer of the receiving vehicle.

8.8 In summary, the ability of trustees of private sector schemes, again without limitation as to their origin and linkage to public sector benefit structures, is governed by the trust deed and rules of the relevant schemes and there is no overriding statutory basis on which such schemes could be forced to transfer their assets and liabilities into another receiving scheme.