<u>MHCLG Draft Pooling Guidance – Lambeth Pension Fund Response</u>

Background

1. To date just under 50% of our assets are either fully pooled or managed under advisory/execution mandates by our regulated company LCIV. We are fully supportive of the pooling and the advantages in terms of reduction in costs, increases in the availability of skilled investment staff and the ways in which pooling will reduce future burdens on Council tax payers. However, the draft guidance is deficient in this respect as it fails to properly understand the extent to which investments and liabilities are interlinked, specifically: in respect of pension fund solvency approaches; cashflow requirements; employer covenants and control of the resulting risk and return profile required between LGPS pension funds. Accordingly, the guidance as written, introduces significant risks of consequence falling on Council tax payers because it is too simplistic in appreciating the relationship to funding risks and accordingly too dogmatic in the approaches that Local Government Pension Funds are being required to follow. The following explains these issues and the rest of our response highlights where the draft guidance is deficient in these respects and how it should be changed to meet our common objectives.

Draft Statutory Guidance

1. The Statutory Guidance is attached as an Appendix. It is separated in to 8 sections as follows:

   Section 1 - Introduction
   Section 2 - Definitions
   Section 3 - Structure and scale
   Section 4 - Governance
   Section 5 - Transition of assets to the pool
   Section 6 - Making new investments outside the pool
   Section 7 - Infrastructure investments
   Section 8 – Reporting

The proposed guidance builds on the Government's original guidance and leaves unchanged the fundamental direction of the pooling agenda, which is for all LGPS investments to be managed through asset pools with very few exceptions. The section are detailed below.

Section 2 Definitions

2. The proposed guidance creates a set of definitions for the key terms involved in asset pooling. I consider that this inclusion is helpful in supporting Stakeholders to interpret the Government's expectations and in standardising language across the scheme.

3. Definitions: Many assets will be retained by funds for a considerable period going forward, for instance infrastructure funds, private equity funds, private

rented sector housing, direct or indirect commercial property investments and certain other illiquid securities. However, there is a difference between those assets that are overseen and/or executed in an advisory manner by a pool company and those that are wholly retained within a LGPS pension fund. The former takes advantage of the increased expertise that is present in Pool companies and the superior results that should ensue for taxpayers, indeed should superior routes to market emerge then pool companies are likely to suggest them – a specific example recently was the sale of 70 private equity mandates and re-investment into a pool vehicle all of which was managed by the pool company. The latter does little to change the status quo and the Government is correct with the focus given to retained assets. However, the Government should recognise in the definitions and in the rest of the guidance those assets managed under advisory and execution mandates where the assets remain in the Fund's name should either be classed as pooled assets or given their own category to show that these assets are benefitting from the increased expertise of pooling.

4. 8.2 to 8.5 For the reasons we have outlined above and in this response we would urge the government to remove the comparison to market capitalised indices and to include those assets that are mid-way to being pooled under advisory and execution mandates as either being a pooled asset or as a separate category.

Section 3 Structure and Scale

5. This section sets out how the Government expects LGPS investment to be structured in future. It states unambiguously that "all administering authorities must pool their assets in order to deliver the benefits of scale and collaboration" (3.1). This is an evolution from the earlier guidance where administering authorities were required to "commit to a suitable pool to achieve benefits of scale".

6. "The selection, appointment, dismissal and variation of the terms of investment managers" will be a matter for asset pools, not administering authorities (3.2). This is consistent with the Government's existing ambitions for pooling, as conveyed in the original 2015 guidance.

7. The proposed guidance creates a requirement for pool companies to be FCA regulated companies (3.4). *Most Pools already an FCA regulated company.*

8. Additionally, pool companies and funds need more nuanced guidance on how they might achieve the correct blend of risk and return to enable funds within the pool to compromise on requirements that meets their Strategic Asset Allocation requirements. It would be necessary to introduce touch points with the procurement process where the pool company liaises with pool funds over mandate requirements, the risks and returns that shortlisted managers are taking and what blends might lead to the best outcomes in terms of risk, return, cost and compromise for individual funds. Failure to follow a model like this might result in an outcome that reduces the amounts pooled by pool companies.

Section 4 Governance

9. This section describes the governance arrangements for pooling and makes clear that pool members (i.e. administering authorities) are responsible for effective governance and for holding pool companies to account (4.2).

10. In addition, the guidance states that local pension boards can scrutinise pool governance and reporting in the interests of members and employers.

11. The proposed guidance makes clear in two places that administering authorities will retain full responsibility for strategic asset allocation:

    - *"Strategic asset allocation remains the responsibility of pool members, recognising their authority's specific liability and cash-flow forecasts" (4.2)*

    - *"Pool members are responsible for deciding their investment strategy and asset allocation and remain the beneficial owners of their assets" (4.7)*

12. These statements provide clarity to both asset pools and administering authorities in interpreting their respective responsibilities.

13. The guidance goes on to differentiate between strategic asset allocation and "tactical" asset allocation, indicating that the latter is "best undertaken by the pool company" (4.8). The guidance does not define which aspects of asset allocation are to be considered tactical, stating that this is a decision for "Pool members collectively through their pool governance bodies". This is a helpful reminder that the interpretation of "tactical" and "strategic" asset allocation decisions should not be imposed on administering authority by the asset pools.

Section 5 Transition of assets to the Pool

14. This section of the guidance details the Government's expectation that the transition of assets to the pool vehicle should take place as quickly and cost effectively as possible and for listed assets, should take place over a relatively short period.

15. However, the guidance also states that in exceptional circumstances pension funds may continue to hold existing investments until maturity before reinvesting funds through a pool vehicle where "the cost of moving the existing investments to a pool vehicle exceeds the benefits of doing so" (5.4).

16. Pool members will need to regularly review their retained assets (those that continue to be invested outside the pool) and the rationale for keeping those assets outside the pool.

17. 5.5 and 5.6 should be expanded to encourage retained assets being overseen on advisory/execution basis where the pool company has the specialist skills available. Rather than a review every three years there should be an ongoing obligation on underlying Funds to recommend any superior approaches which would be expected to maximise the funds manage by pool companies.

Section 6 Making new investments outside the Pool

18. The Government expects pool members to make all new investments via pools and after LGPS funds review their investment strategies in 2020, new investments will be made outside of the pool only in very limited circumstances (6.1).

19. The guidance proposes that up to 5% of an LGPS pension fund's assets may be invested outside of the pool as "local assets". Local assets will either be invested in geographically local initiatives or in products tailored to the pool member's specific liabilities.

20. The guidance also provides for administering authorities to invest in pools other than their own in certain cases (6.2).

21. 6.1 and 6.2. Meeting solvency, cashflow and covenant requirements means that the limited circumstances proviso and short timescale (2020) mean that the 5% limit is of no effect from 2020. It will just take too long for the compromises and understanding of SAA's to be completed across all asset classes. The outcome is likely to be that if a fund isn't able to pool by 2020 to meet the strategic goals then other investments must be made – but limiting these to 5% in each instance means there will be many of them. We don't think that this is your intention.

22. Accordingly, the 5% limit should be removed and the limited circumstances expanded to include the principles that we set out above including the preference that once pool companies have the relevant skill set they should be involved in any future selections together with a presumption that they manage the resulting mandates whether that be directly for more than one fund.. 6.4 should be changed accordingly.

Section 7 Infrastructure

23. The original guidance outlined the Government's objective to increase the LGPS' overall participation in infrastructure investment as a key aim of pooling. The refreshed guidance reiterates this goal but does not set a target either for pool members or for pools. Instead pool members are expected to set an ambition on investment in this area and pools are expected to develop the capability to enable an expansion of infrastructure investment at pool level.

24. 6.3 This paragraph is essential in order that the Government's aims to increase infrastructure investment gains momentum. Different pool companies are likely specialise in different types of infrastructure assets and specialism is more likely to gain the scale to compete with foreign pension funds that invest in these assets. We recognise that pool companies are likely to want this provision removed from the guidance as it removes their monopoly on pooled funds and affects their business plans. However, we would urge the Government to resist these calls from pool companies as it would in our view damage scalability opportunities and be generally negative in removing a small element of competitive pressure on pool companies.

Section 8 Reporting

25. Pool members will need to expand their reporting output in their Pension Fund Annual Reports in order to demonstrate the financial outcomes of pooling. This is consistent with overall rationale of cost reduction, which is pivotal for pooling, and the enhanced requirements will allow stakeholders to understand whether the pooling agenda has been successful.

26. 3.6 The Fund is in agreement with the guidance; however a reasonable period will be determined by the Fund.

27. 4.4, 4.8 and 4.9 These paragraphs do not recognise the risks and returns required for funds when assessing appropriate investments, as set out above. The guidance would be significantly improved by appreciating these factors and setting out a new way forward for investments that might not be just vanilla capital weighted equity/bond mandates with managers chosen by the pool company.

28. Responsible Investment: The consultation is notably light on wording in this area. Given the importance of this subject, we recommend wording on this subject, and the potential implications of pooling, are added to the guidance.

Conclusion

29. The proposed guidance represents an evolution not a revolution of the asset pooling regime in the LGPS. The document makes clear that administering authorities, will retain responsibility for strategic asset allocation and that manager selection will be a matter for the Asset Pool.