

**PENSIONS COMMITTEE**  
**7 DECEMBER 2016****LGPS CENTRAL GOVERNANCE**

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**Recommendation**

- 1. The Chief Financial Officer recommends that the following recommendations be approved subject to a condition that a cost share agreement is agreed with all LGPS Central pool members that ensures value for money in the opinion of the Chief Financial Officer for the Worcestershire County Council Pension Fund from entering into the LGPS Central investment pool:**
  - a) To enter into a joint agreement with Derbyshire County Council, Leicestershire County Council, Nottinghamshire County Council, Shropshire Council, Staffordshire County Council, Wolverhampton City Council and Cheshire West and Chester Borough Council to establish a joint pension fund investment pool, in accordance with the requirements of the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016; to be overseen by a Joint Committee established under s102 of the Local Government Act 1972;**
  - b) That Council be recommended to establish a Joint Committee with the participating authorities under s102 of the Local Government Act 1972 to oversee LGPS Central arrangements and that the Head of Legal and Democratic Services be authorised to finalise the formal terms of reference for such a Joint Committee in consultation with the Chief Financial Officer;**
  - c) That the Chairman of the Worcestershire County Council Pensions Committee, or his nominated representative be appointed act as the Council's representative on the Joint Committee;**
  - d) That the Director of Governance and the Director of Finance of Cheshire West and Chester Borough Council provide governance and administrative support to the Joint Committee on behalf of the participating Councils, subject to an appropriate cost sharing agreement agreed by the Chief Financial Officer in respect of officer time and other expenses;**
  - e) To become a joint shareholder of LGPS Central as a private company, limited by shares held solely by the participating funds, on a 'one fund, one vote' basis and incorporated for investment management purposes and regulated under the Financial Services and Markets Act 2000;**

- f) That the Chairman of the Worcestershire County Council Pensions Committee, or his nominated representative, exercise the Council's voting rights as a shareholder of LGPS Central;**
- g) That the Chief Financial Officer represent the Council on a Practitioners Advisory Forum, providing joint officer support to the Joint Committee and Shareholders; and**
- h) To authorise delegated powers to the Chief Financial Officer to enter into all necessary legal agreements to establish a joint asset pool and investment management company, as outlined in this report, and to agree the Initial Strategic Plan and the Cost Sharing Schedule.**

### **Purpose of the Report**

- 2. This report outlines the changes that will be required to the operational and governance arrangements for the Worcestershire County Council Pension Fund following recent amendment of the LGPS Investment Regulations.
- 3. The revised regulations require all administering authorities in England and Wales to enter into joint (pooled) arrangements for the management of their investment assets, with effect from 1 April 2018, in order to achieve scale economies and increase investment capacity.
- 4. The Worcestershire County Council Pension Fund has been working with seven partner funds on a proposal which will meet the criteria for pooling laid down by the Secretary of State, by establishing a jointly owned investment management company, to be known as 'LGPS Central'.
- 5. The recommendations will allow the Council to comply with updated LGPS Investment Regulations which came into effect in November 2016, requiring all administering authorities to commit to an investment pooling arrangement which meets the criteria and guidance laid down by the Secretary of State in November 2015.
- 6. Where authorities fail to comply with the criteria and guidance, the Secretary of State has powers to intervene, and to issue a Direction requiring changes to investment strategies and investment management arrangements, or the transfer of the investment functions of an administering authority, either to himself or a nominated party.
- 7. The proposal to establish LGPS Central is supported by a comprehensive business case, which demonstrates the potential for significant savings in investment costs and management fees over the longer term for the pool as a whole, without detriment to investment performance and local accountability. However the business case for Worcestershire County Council Pension Fund on a value for money basis is dependent on the cost share agreement, which is currently being finalised.

### **Background**

- 8. The LGPS is one of the largest funded pension schemes in the world with combined assets of around £200 billion. These are managed by 89 local

administering authorities, who historically, have maintained separate arrangements for the management of scheme assets, overseen by their respective Pension Fund Committees.

9. Between them it is estimated that administering authorities incur total administrative and management costs of around £500 million per year, a significant proportion of which relates to investment management fees paid to external fund managers. Funds often use the same managers, offering the same or similar services but appointed under separate agreements and on different fee terms.

10. Funds also vary significantly in scale; large funds enjoy direct access to a wide range of investment markets and products and can often negotiate more competitive fees, whilst smaller funds have more restricted options due to lower levels of investible resources, and expertise and have less negotiating power in the market.

11. Over the past two and half years the government has explored a number of options for improving the efficiency and sustainability of the scheme, and has undertaken extensive consultation on the potential to deliver savings through greater collaboration. A national cost benefit exercise, led by Hymans Robertson concluded that significant savings could be achieved through greater use of collective investment approaches, provided that certain regulatory restrictions were removed.

12. Subsequently, the government announced its intention to introduce a new regulatory framework which would facilitate collective investing and issued guidance and criteria to help administering authorities to develop proposals for pooling aimed at reducing costs and improving efficiency. Initial proposals were required by February 2016, followed by more detailed business case submissions in July 2016, with a target implementation date of 1<sup>st</sup> April 2018. The government also announced that 'backstop' powers would be introduced to allow the Secretary of State to intervene where authorities failed to bring forward sufficiently ambitious proposals in accordance with the guidance and criteria issued

## **LGPS Central**

13. Prior to the government's announcement, the Worcestershire County Council Pension Fund has already established close working links with a number of other funds in, and around, the Midlands area and had begun to explore the scope for wider collaboration, starting with a successful joint procurement exercise in 2015, which resulted in a substantial fee saving on the funds' passively managed equity portfolio.

14. These informal links become the starting point for wide discussions in the context of the formal requirement for pooling, resulting in a joint proposal from Cheshire, Derbyshire, Leicestershire, Nottinghamshire, Shropshire, Staffordshire, West Midlands and Worcestershire to create 'LGPS Central', with combined assets of £35 billion.

15. Following confirmation from the Minister that this proposal was acceptable, a joint working group of officers, supported by external advisors, developed a detailed business case setting out how LGPS Central will meet the four key assessment criteria laid down by the government:

- a) Criteria 1 – Asset pool(s) that achieve the benefits of scale (>£25billion);
- b) Criteria 2 – Strong governance and decision-making;
- c) Criteria 3 – Reduced costs and value for money; and
- d) Criteria 4 - Improved capacity and capability to invest in infrastructure.

16. Detailed reports have been presented to the Worcestershire County Council Pensions Committee, explaining the key elements of the business case and seeking its approval for the proposed governance, oversight and management structure of the pool, which is summarised in Appendix 1 to this report.

17. The structure will allow participating funds to exercise control (both individually, and collectively) over the new arrangements, not only as investors in the pooled fund, but also as shareholders of the operator company.

18. Whilst assets will be managed on a pooled basis, each fund will be able to exercise their investor rights independently, although clearly, benefits of scale will most effectively be harnessed where parties work together, in a co-ordinated way to align their decision-making. An important example would be social, environmental and governance policies and policies on the exercise of voting rights, where cross-voting between funds within the same pool would be both costly to administer and counter-productive.

19. The Joint Committee will be the forum for discussing common investor issues, and for collective monitoring of the performance of the pool against the objectives set out in the LGPS Central business case submission. It will however, have no formal decision-making powers and recommendations will require the approval of individual authorities, in accordance with their local constitutional arrangements.

20. The Shareholders, operating under company law, will have formal decision making powers. The Worcestershire County Council Pension Fund will have equal voting rights alongside the other participating funds, and unanimous decisions will be required on key strategic matters, which will be specified in the company Shareholders Agreement and Articles of Association. This will include the appointment and dismissal of the company's senior executives, approval of the company's strategic plan and any significant financial transactions, such as major acquisitions and lending or borrowing. A deadlock resolution procedure is included within the Shareholders Agreement, along with mediation and arbitration processes, if required, to resolve deadlocked decisions on key strategic matters.

21. The degree of control to be exercised by the Shareholders through their reserve powers will be greater than is generally the case, in order to satisfy the Teckal exemption criteria in the Procurement Regulations and allow the company to undertake services on behalf of the investor funds without a formal procurement process.

22. The government has also made clear their expectation that pooled entities must be registered with the Financial Conduct Authority (FCA) and regulated under the Financial Services and Markets Act 2000, to ensure appropriate safeguards over the management of client monies. As such, the new LGPS Central company will be subject to on-going oversight by the regulator and key management positions, including the company directors will need to be 'approved persons', able to demonstrate appropriate knowledge, expertise and track record in investment

management. They will also carry significant legal personal liability for their actions and decisions.

23. The relative merits of buying, or renting an established operator to manage the day to day running of the pool, have been carefully considered against the benefits of setting up a jointly owned company, with associated shareholder rights. The constituent funds unanimously agreed that the latter option, whilst more expensive, offers significant advantages in terms of great flexibility and control, and this is the basis upon which the business case has been developed.

24. Staff who are currently employed on behalf of the partner Funds to manage their investments will transfer under the Transfer of Undertakings (Protection of Employment) Regulations (TUPE) to the new company. As the Worcestershire County Council Pension Fund does not currently have an in-house investment team, no staff transfer implications are anticipated for the Council, although the ability to access internal investment resources through the pool offers potential for additional future savings.

25. The detailed business case has been reviewed by a joint DCLG/HMT Review Panel, and Ministerial consent to proceed has been received.

### **Impact on the role of the Worcestershire County Council Pension Fund Pension Committee**

26. For the most part, the role of the Pensions Committee will be unaffected by the implementation of pooling and the creation of LGPS Central. The Pensions Committee will continue to be responsible for monitoring the overall management, performance and administration of the fund, and for setting investment strategy, including the overall allocation of assets, which is the critical factor in determining investment performance.

27. Importantly, the Pensions Committee will also continue to be responsible for communicating with individual scheme members, whose benefits are guaranteed in law, and are therefore not affected by the new pooling arrangements or investment performance.

28. Responsibility for appointing investment managers and overseeing their performance, including any decision to dismiss, will however transfer to the pool operator, as will tactical decisions on the implementation of the overall investment strategy and the choice of specific investment vehicles.

29. The role of the Pension Investment Advisory Panel will be more fundamentally impacted by the pooling proposals, as its remit is focussed specifically on the review of investment manager performance and other service provider issues, which will become the responsibility of the pool operator. With reduced terms of reference it may be that the residual role of the Advisory Panel could be subsumed back in to the main Pension Committee, thereby streamlining the overall governance arrangements and reducing the demands on Member time. It should be noted however, that the transition of assets into the pool is likely to be phased over a number of years, and that the Advisory Panel will have an important role in the interim in making sure that good governance is maintained over both transferred and non-transferred assets.

30. Changes to the terms of reference for the Pensions Committee and the Pension Investment Advisory Panel will be recommended to Full Council prior to the LGPS Central operation start date on 1 April 2018.

### **Pooling costs**

31. The estimated cost of setting up the jointly owned company is up to £4m, this will be shared equally between the participating funds, with Worcestershire's share being around £500,000. There will also be significant transition costs as existing investment mandates are unwound and funds are transferred into new collective investment vehicles. It is not possible to accurately predict these costs, but the business case includes an estimate of £50m. Transition costs will also be shared between the funds on a fair and equitable basis.

32. In addition, as the new company will be a regulated entity under FCA rules, it will need to hold regulatory capital to guarantee its solvency. The regulatory capital requirement is expected to be in the region of £8m (£1m per fund).

33. If approved, Worcestershire's share of all costs (including the regulatory capital) will be met from the pension fund, and there will therefore be no direct impact on the Council's revenue or capital budgets.

34. Estimated net total savings for the pool are in the region of £182m over the period from 2018/19 to 2032/33, with annual savings of around £29m being achieved by the end of this period. However Worcestershire, over the planning period of 15 years, is forecast to incur additional costs of £0.3 million according to the Base Business Case. Following direction from the DCLG, this planning period has been extended to 16 years which has resulted in a small (£2,000) net benefit.

35. It is therefore of key importance to the Fund, due to the qualification attached to the recommendations in this report, that the Base Business Case be revised based on an updated cost share agreement that is currently to be finalised, to demonstrate value for money for the Fund before LGPS Central legal documents can be signed / sealed in April / May 2017.

### **LGPS Central key risks**

36. The key risks are:

- a) failure to achieve the statutory implementation deadline of 1 April 2018;
- b) failure to manage costs and savings in line with the agreed business case;
- c) failure to meet the requirements of the FCA regulator; and
- d) failure to recruit appropriately skilled and experienced senior personnel to the new company.

37. Comprehensive programme governance arrangements are in place to ensure that the statutory deadline for the implementation of pooling is achieved and that costs and savings are managed in accordance with the business case. The s151 officers of each of the participating funds sit on the LGPS Central Programme Board and regular joint meetings are held between the Chairs and Vice-Chairs of the

respective Pension Fund Committees to ensure effective member oversight of progress and delivery. The Worcestershire County Council Pensions Committee and Local Pensions Board are also being updated regularly on key developments and decisions, as are the fund employers.

38. Expert advisers have been appointed to provide support on legal matters, FCA registration, taxation and overall programme management, and professional recruitment consultants are being appointed to assist and advise on executive recruitment and remuneration.

### **Operator setup options**

39. The options of renting or buying an operator to manage the pool (rather than setting up a wholly owned company), have been considered and rejected due to market risk (limited supplier choice), and on governance grounds. The option of setting up a non-incorporated shared service arrangement has also been rejected due to significant regulatory risk.

### **Contact Points**

#### County Council Contact Points

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#### Specific Contact Points for this report

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### **Supporting Information**

- Eversheds- LGPS Central Governance Structure – Appendix 1
- Marcus Jones MP Letter to Central Pool – Appendix 2

### **Background Papers**

In the opinion of the proper officer (in this case the Chief Financial Officer) the following are the background papers relating to the subject matter of this report:

LGPS Central business case submission to government 15 July 2016.

Agenda papers and Minutes of the meetings of the Committee held on 26 September 2016, 28 June 2016, 27 April 2016, 3 February 2016 and 14 December 2015.