

COUNCIL
12 JANUARY 2017**REPORTS OF COMMITTEES****(a) MATTERS WHICH REQUIRE A DECISION BY COUNCIL**

LGPS Central Governance**Recommendation**

1. **The Pensions Committee recommends that, 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) **a Joint Committee be established with the participating authorities under s102 of the Local Government Act 1972 to oversee LGPS Central arrangements in accordance with this report 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; and**
 - b) **Council endorses the proposal to become a joint shareholder of LGPS Central as a private company limited by shares as set out in this report.**
2. The revised LGPS Investment 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.
3. 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'.
4. The Pensions Committee has agreed that the following recommendations are 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.

5. The changes agreed by the Pensions Committee 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 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.

Arrangements for the appointment of the County Council's External Auditor

Recommendation

40. The Audit and Governance Committee recommends that the Council 'opt in' to the appointing person arrangements proposed by the Public Sector Audit Appointments (PSAA) for the purpose of appointing the County Council's external auditors as set out in the report (option 3).

Background

41. The Audit Commission was discontinued by the Local Audit and Accountability Act 2014. Transitional arrangements were established for the appointment of external auditor and the setting of audit fees for all local government and NHS bodies in England. On 5 October 2015 the Secretary of State for Communities and Local Government (CLG) determined that the transitional arrangements for local government bodies would be extended by one year to also include the audit of the accounts for 2017/18.

42. The County Council's current external auditor is Grant Thornton UK LLP, who was appointed under a contract let by the Audit Commission. The contract is currently managed by Public Sector Audit Appointments Limited (PSAA), the transitional body set up by the Local Government Association (LGA) with delegated authority from the Secretary of State for CLG.

43. The County Council's current annual external audit fees are £95,000. Over recent years the County Council's external audit fee has reduced by around 45%. This reduction has been delivered through a combination of factors including new contracts negotiated nationally with external audit providers and savings from closure of the Audit Commission.

44. When the current transitional arrangements come to an end on 31 March 2018, the County Council will potentially be able to move to local appointment of their External Auditor. There are a number of routes by which this can be achieved, each with varying risks and opportunities, which are explored further in this report.

45. The scope of the external audit and the issuance of the Code of Audit Practice will continue to be specified nationally by the National Audit Office (NAO). Any prospective provider of External Audit services will need to demonstrate that they have the required skills and experience and be registered with a Registered Supervising Body approved by the Financial Reporting Council. The registration process has not yet commenced and so the number of External Audit providers is still to be confirmed. It is anticipated that there will continue to be External Audit Providers of sufficient quality to meet our needs at the County Council.

Options for local appointment of External Auditors

46. There are three broad options open to the County Council under the Local Audit and Accountability Act 2014 (the Act). In each case, a broad summary of the respective advantages and disadvantages are set out in this section

Option 1 - To make a stand-alone appointment

47. In order to make a stand-alone appointment the County Council will need to set up an Auditor Panel. The members of the panel must be wholly or a majority independent members as defined by the Act.

48. Independent members for this purpose are independent appointees, which excludes current and former elected members (or officers) and their close families and friends. This means that elected members will not have a majority input to assessing bids and choosing which External Auditor to award a contract for the Council's External Audit.

Advantages/benefits

49. Setting up an auditor panel allows the County Council to take maximum advantage of the new local appointment regime and have local input to the decision.

Disadvantages/risks

50. Recruitment and servicing of the Auditor Panel, running the bidding exercise and negotiating the contract is estimated by the LGA to cost in the order of £15,000 plus on going expenses and allowances.

51. The County Council may not be able to take advantage of reduced fees that may be available through joint or national procurement contracts.

52. The assessment of bids and decision on awarding contracts will be taken by independent appointees and not solely by elected members.

Option 2 - Set up a Joint Auditor Panel / local joint procurement arrangements

53. The Act enables the County Council to join with other authorities to establish a joint auditor panel. Again this will need to be constituted of wholly or a majority of independent appointees. Further legal advice will be required on the exact constitution of such a panel having regard to the obligations of each Council under the Act and the County Council will need to liaise with other local authorities and/or public bodies to assess the appetite for such an arrangement.

Advantages/benefits

54. The costs of setting up the panel, running the bidding exercise and negotiating the contract will be shared across a number of authorities and/or public bodies.

55. There is greater opportunity for negotiating some economies of scale by being able to offer a larger combined contract value to the firms.

Disadvantages/risks

56. The decision making body may be further removed from local input, with potentially no input from elected members where a wholly independent auditor panel is used or possible only one elected member representing each Council and/or public body, depending on the constitution agreed with the other bodies involved.

57. The choice of External Auditor could be complicated where individual Councils and/or public bodies have independence issues. An independence issue occurs where the auditor has recently or is currently carrying out work such as consultancy or advisory work for the County Council.

58. Where conflict may occur, some auditors may be prevented from being appointed by the terms of their professional standards. There is a risk that if the joint auditor panel choose an External Audit provider that has a conflict then the County Council may still need to make a separate appointment with all the attendant costs and loss of economies possible through joint procurement.

Option 3 - Opt-in to a Sector Led Body (Preferred option)

59. The PSAA has been specified by the Secretary of State for CLG as the Appointing Person for principle local government bodies, and as such will make External Auditor appointments for bodies that choose to opt in to the national appointment arrangements. This arrangement is sometimes described as a Sector Led Body (SLB) option.

60. Proposals are for External Auditors to be appointed under this arrangement for an initial period of five years commencing 1 April 2018.

Advantages/benefits

61. The costs of setting up the appointment arrangements and negotiating fees would be shared across all opt-in authorities and or public bodies. By offering large contract values, potential providers of External Audit may be able to offer better value for money given the size of the audits collectively being procured.

62. Any conflicts at individual authorities would be managed by the SLB who would have a number of contracted firms to call upon. The appointment process would not be made locally. Instead a separate body set up to act in the collective interests of the 'opt-in' authorities, in a similar fashion to the Audit Commission arrangements of

the past. The LGA are considering setting up such a body utilising the knowledge and experience acquired through the setting up of the transitional arrangements.

Disadvantages/risks

63. Individual elected members will have less opportunity for direct involvement in the appointment process other than through the LGA and/or stakeholder representative groups.

64. In order for the SLB to be viable and to be placed in the strongest possible negotiating position the SLB will need Councils to indicate their intention to opt-in before final contract prices are known.

Preferred Option

65. Option 3 – Opting into a Sector Led Body for the purpose of appointing the County Council's External Auditor is recommended for the reasons set out in Section 3. The decision is reserved for Full Council within the Local Audit and Accountability 2014 Act (the Act).

66. The County Council have until December 2017 to make an appointment of external auditors from April 2018. In order that more detailed proposals can be developed the Committee is asked to recommend Option 3 as the County Council's preferred approach and for this to be communicated to the PSAA.

67. The closing date for opting in to the PSAA is 9 March 2017 to enable audit contracts to be awarded by end of June 2017.

Risk Management

68. PSAA have indicated that they require a commitment from the County Council by March 2017. Whilst there is no immediate risk to the County Council, early consideration of its preferred approach will enable detailed planning to take place so as to achieve successful transition to the new arrangement in a timely and efficient manner and maximise the opportunity to achieve Value for Money from its External Audit services.

69. Providing the LGA with a realistic assessment of our likely way forward will enable the LGA to invest in developing appropriate arrangements to support the County Council.

Contact Points

County Council Contact Points

County Council: 01905 763763

Worcestershire Hub: 01905 765765

Specific Contact Points for this report

Simon Lewis, Committee Officer

Tel: 01905 846621

Email: slewis@worcestershire.gov.uk

Supporting Information

The following supporting information is available electronically. Hard copies will also be

made available in the Members' area and in County Hall Reception:

- 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 Head of Legal and Democratic Services) the following are the background papers relating to the subject matter of this report:

Agenda papers for the meeting of the Pensions Committee held on 7 December 2016 and the Audit and Governance Committee on 9 December 2016.