Local Government Pension Scheme Pooling: Spring Progress Report

Pool: LGPS Central

Date: 4th May 2018

INTRODUCTION

This report has been produced by the 8 Partner Funds in collaboration with LGPS Central Ltd. We believe it shows significant progress in the development of our Asset Management Vehicle and the ability to deliver on the aspiration of the original business case.

It highlights significant savings made by Partner Funds, the establishment and regulatory authorisation of LGPS Central Limited and of its pooling vehicle, an Authorised Contractual Scheme (ACS), by the Financial Conduct Authority (FCA), implementation of effective governance, the creation of several ACS sub-funds and an initial transfer of assets.

All parties continue to work together in partnership to ensure the collaboration is a success through the development of investment offerings that represent value to the Administering Authorities as the ultimate Asset owners.

<u>**Criterion A: Scale**</u>
The Partner Funds of the LGPS Central Pool (the Pool) are responsible for the management of £45bn of pension fund assets. The Partner Funds are Cheshire Pension Fund, Derbyshire Pension Fund, Leicestershire Pension Fund, Nottinghamshire Pension Fund, Shropshire Pension Fund, Staffordshire Pension Fund, West Midlands Pension Fund, the West Midlands Integrated Transport Fund and Worcestershire Pension Fund. The Pool has created LGPS Central Limited (LGPSC, the Operator or the Company) as the Pool's asset management company and it is ultimately expected to manage the majority of these assets on behalf of the Partner Funds. LGPSC is authorised by the FCA to provide investment offerings in three key areas: 1. An the operator of an Authorised Contractual Scheme (the ''ACS''); 2. Other Collective Investment Vehicles (e.g. Limited Partnerships); and 3. Discretionary, advisory and execution only mandates covering certain legacy assets of the Partner Funds managed under Client Services Agreements. LGPSC is responsible for the oversight and management of the three key elements noted above. The first two elements will be used to manage the pooled assets of the Partner Funds, with the third element covering certain legacy assets from individual Partner Funds. The ACS has been authorised by the Financial Conduct Authority, and the first three ACS sub-funds were launched on 1 April 2018. The Other Collective Investment Vehicles will be used to manage more illiquid assets, e.g. private equity and infrastructure.

Based on asset values at 31 December 2017, the total value of assets owned by the Partner Funds was £45.2bn. It is anticipated that the investment management of all assets, except Bulk Annuity Buy-Ins, LDIs, Life Policies and Cash, will be transitioned into LGPSC over time, with all transitions subject to value for money appraisals. Based on asset values at 31 December 2017, the assets which are currently expected to be ultimately managed by LGPSC will be in the region of £32bn.

Since the last update, the Partner Funds have decided to retain the management of the Life Policies within the Partner Funds utilising a previous collaborative procurement undertaken prior to the establishment of LGPS Central whilst the company develops an offer that compares on value for money grounds. This will be kept under review as the company develops its offer in this area.

Building on the launch of the first three ACS sub-funds, the transition plan includes the launch of a further fifteen sub-funds over the next three years, covering equities, fixed income and direct property (subject to the satisfactory resolution of several tax issues). The provisional timing of the launch of the ACS sub-funds is set out below.

Month	**ACS Sub-Fund**	**Estimated Assets Under Management £m**
Launched	UK Equities Passive (Internal)	1,271
	Global Equities Passive (Internal)	4,126
	Dividend Growth Fund (Internal)	268
September 2018	Global Equities Active (External)	2,853
	Global Equities Active (Internal)	500
December 2018	Emerging Market Active (External)	2,414
	UK Equities Active (Internal)	1,246
	2018/19 Total	**12,678**
April 2019	UK Conventional Active (Internal)	391
	Index Linked Active (Internal)	558
	Corporate Bonds Active (External)	2,249
	MAC Active (External) (60%)	759
	Emerging Market Debt Active (External)	465
September 2019	Property Direct (External)	2,248
	2019/20 Total	**6,670**

April 2020	UK Equities Active (External)	1,460
	US Equities Active (External)	783
	MAC Active (External) (40%)	506
September 2020	Japanese Equities Active (External)	721
	Asia Pacific Equities Active (External)	462
	European Equities Active (External)	318
	2020/21 Total	**4,250**
	Total	**23,598**

This timetable is currently being reviewed by LGPSC in collaboration with the Partner Funds following the recruitment of the majority of the company Investment Directors, with demand, sustainability and value for money being key considerations for the development of a sub-fund. Based on asset values at 31 December 2017, the total value of assets expected to be transitioned into ACS sub-funds is approximately £24bn. Prior to the launch of further ACS sub-funds, the legacy assets destined for these sub-funds will either be managed by the Partner Funds or by LGPSC under either discretionary or advisory client services agreements.

Alternative legacy assets (e.g. infrastructure, private equity, private debt, etc.) will be either managed by the Partner Funds or by LGPSC under an advisory client services agreement. As the legacy assets unwind, a process which is expected to take more than ten years, the assets will be transitioned into a series of Other Collective Investment Vehicles created by the company. The timetable for the launch of these Other Collective Investment Vehicles is being developed by LGPSC in collaboration with the Partner Funds, with demand, sustainability, value for money and the suitability of the structure being key considerations. The aspiration remains for all Assets within the original business case to be managed by LGPSC, subject of course to the development of appropriate product offerings.

The assets which will be managed outside the LGPS Central Pool are:

1. Bulk Annuity Buy-In contracts held in relation to the pensioners' liabilities within the West Midlands Integrated Transport Authority (WMITA) Pension Fund (£255m at 31 March 2017); these assets are only valued once a year at the year-end. The WMITA Pension Fund will hold the Bulk Annuity Buy-In outside the LGPS Central Pool indefinitely because it is a liability matching asset, specific to the members of the WMITA Pension Fund.
2. Any existing or future investments in LDIs held by Partner Funds will be managed outside of the LGPS Central Pool (£72m at 31 December 2017).
3. The management of the Life Policies will remain with the Partner Funds (£11.9bn at 31 December 2017) on value for money considerations. This will be kept under review and it should be noted that the current fees payable for the management of the majority of the Life Policies assets were negotiated as part of the "Seven Shires" collaboration which involved six of Central's Partner Funds.
4. Cash held by the Partner Funds for operational purposes £1.2bn at 31 December

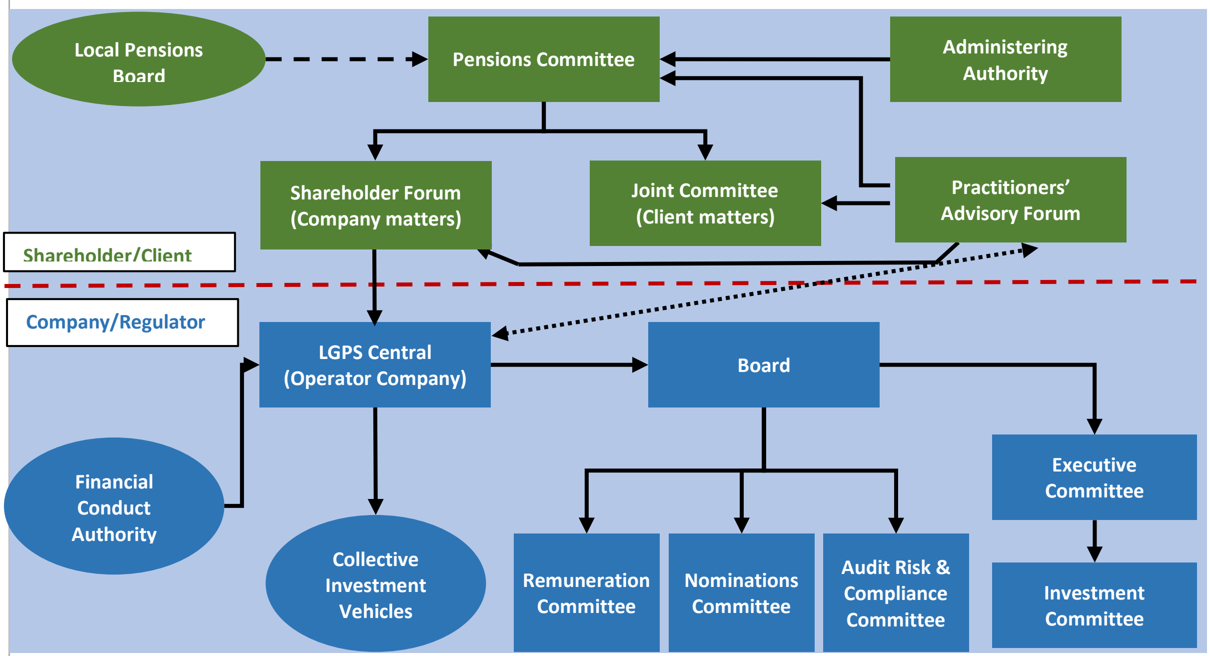
2017).

Based on the asset values at 31 December 2017, the total value of assets which are currently expected to be managed outside of LGPSC will be £13.5bn.

Progress against the transition timetable will be reported transparently to LGPS Central's Joint Committee which is a public forum.

Criterion B: Governance

The governance arrangements currently in operation for the LGPS Central Pool, are set out in the diagram below, are now well established,



The **LGPS Central Joint Committee** has been set up in accordance with provisions of the Local Government Act 1972 to provide oversight of the delivery of the objectives of the Pool, the delivery of client service, the delivery against the LGPS Central business case and to deal with common investor issues. The membership of the Joint Committee consists of one elected member from each Council within the LGPS Central Pool. The first meeting of the Joint Committee took place on 23 March 2018 and at that meeting it was agreed that a Trade Union representative would be appointed as a non-voting member of the Joint Committee to represent the scheme members across the Councils' pension funds.

The primary role of the **Shareholders' Forum** is to oversee the operation and performance of LGPS Central Ltd and to represent the ownership rights and interests of the Shareholding Councils within the LGPS Central Pool. The Shareholders' Forum is independent of the Company and its meetings are distinct from Company meetings, however, members of the Shareholders' Forum represent the Councils at Company Meetings. The Councils as individual investors in the Company have in place local arrangements to enable their Shareholder representatives to vote at Company meetings.

The Shareholders' Forum held its first formal meeting on 20th February 2018, having operated in shadow form during 2017.

The **Practitioners' Advisory Forum (PAF)** is a working group of officers appointed by the Shareholding Councils within the LGPS Central Pool to support the delivery of the objectives of the Pool and to provide support for the Pool's Joint Committee and Shareholders' Forum. PAF seeks to manage the Pool's conflicting demands and interests, either between the participating Councils or between the Councils (collectively) and the Company, recognising that speaking with "one voice" reduces the duplication of costs and resources and maximises the benefits of scale.

Terms of Reference have been approved for the Joint Committee, the Shareholders' Forum and the Practitioners' Advisory Forum. These are "live" documents which are likely to evolve as the practical day to day experience of working within the Pool evolves.

LGPSC is authorised as the operator of the ACS and to provide services to the Partner Funds by the FCA. The company is therefore subject to the regulator's conduct of business rules and has established its internal governance framework to ensure strict adherence both to its regulatory obligations to the FCA and with the Companies' Acts.

The Company Board comprises a non-executive Chair and two further non-executive directors. The Chief Executive Officer (CEO) and the Chief Operating and Financial Director (COFO) are executive Board members.

To support its work, the Board has established three sub-committees:

1. **Remuneration Committee**. Its core purpose is to provide oversight of the Company's regulatory compliance in respect of "Code Staff", to keep under review the Company's pay and benefits framework to ensure that it remains competitive, and to recommend any significant changes in the pay and benefits framework to Shareholders for their approval. The Committee will meet at least twice during the year.

2. **Audit, Risk and Compliance Committee**. Its core purpose is to ensure the integrity of the Company's financial statements and the financial reporting process, oversight of the Company's compliance with legal and regulatory requirements, performance of the internal audit function, checking the effectiveness of the Company's systems of internal controls and policies, and the effectiveness of the Company's procedures for risk assessment and risk management. It will meet at least four times during the year.

3. **Nominations Committee**. Its core purpose is the evaluation of the board of directors, examining the skills and characteristics that are needed in board candidates, and reviewing corporate governance policies. It will meet at least twice during the year.

The Board has created an **Executive Committee** (ExCo) which is chaired by the CEO. In addition to the COFO, ExCo members are the Chief Investment Officer (CIO), Chief Compliance and Risk Officer (CCRO) and General Counsel (GC). The ExCo has primary authority and responsibility for the day-to-day management of the Company's asset management business, all operational and financial functions, the risk, compliance and legal functions, and for the formulation and implementation of the Company's strategy and budget, subject to the strategy, budget, policies and delegations approved by the Board from time to time.

The Board has also created an **Investment Committee** (IC) which is subordinate to ExCo and is chaired by the CIO. In addition to the CIO, IC members will be the Interim DCIO, six Investment Directors, the Director of Responsible Investment and Engagement and the CCRO. The IC has primary authority for the day-to-day management of the Company's investment management function, and for the formulation and implementation of the Company's investment strategy and product development, under the direction and oversight of the ExCo, and subject to the investment strategy and products approved by the Board from time to time.

Assets allocation decisions remain with the Partner Funds. Manager selection for assets transitioned into the ACS and for assets managed under discretionary agreements by the Operator is the responsibility of LGPS Central Limited. Manager selection for the remainder of the Pool's assets currently remains with the Partner Funds. The Operator is responsible for selecting the custodian for the assets in the ACS; the Partner Funds are responsible for selecting the custodian for the remaining assets.

A suite of reports has been designed in order to meet the regulatory requirements for the ACS unitholders and for the segregated mandates. For the ACS unitholders this includes transactional based reporting, provided through the transfer agent, and periodic performance reports. For the segregated mandates this includes both transactional and performance reports provided on a periodic basis.

Discussions have been held with Partner Funds to identify the type and style of reporting that will be required and the Operator is designing appropriate reports. For ACS funds these reports will be issued monthly and initially follow a standard 'fund fact sheet' format. They will disclose performance returns against benchmark, sector and attribution analysis. Discretionary funds managed by the Operator will contain the same information plus detailed transaction and portfolio holding data. Both styles of report will contain an investment commentary.

Development of the product offer is a collaborative process between the Company and the Partner Funds to ensure that the Operator's products will enable each pension fund to deliver its respective investment strategy. An Investment Working Group has been set-up as a sub-group of the Practitioners Advisory Forum to collectively establish the needs of the Partner Funds and to collaborate with the Operator on the development of appropriate products. This is very much a two-way process. LGPSC will bring suggested product ideas and innovative solutions for the delivery of strategies to the Partner Funds.

A Compliance Monitoring Plan has been approved by the Board of the Company and monitoring is taking place in line with this plan. A Risk Manager has been recruited and is developing an appropriate dashboard for monitoring and controlling risks on the portfolios under management. A Risk Management Framework has been implemented to identify risks and to implement mitigating controls so that the residual risk is within the risk appetite. KPMG have been engaged to provide Internal Audit services and discussions have taken place as to the scope and delivery of the audit plan.

A Business Continuity Plan has been established. A Counterparty Risk Committee has reviewed and approved the relationships with all brokers and counterparties utilised. The Audit, Risk & Compliance Committee has held several meetings during which the compliance and risk frameworks have been discussed and agreed. Professional Indemnity Insurance is in place.

The Partner Funds are currently developing a Pool Risk Register to follow on from the project implementation Risk Register. This will include items from the Company's Risk Register, risks surrounding overall Pool governance and Partner Fund pooling risks.

The proposal for cost benchmarking by the Partner Funds is covered in the following section. Governance and performance benchmarking for the Pool will be developed by the Partner Funds and will take into consideration developments at the other Pools on benchmarking.

Criterion C: Reduced Costs and Value for Money

Implementation costs for the establishment of the Operator are forecast at £4.0m, £0.3m lower than those forecast in the Autumn 2017 Progress Report, reflecting an agreement with HMRC on the VAT treatment of the implementation costs which has resulted in no irrecoverable VAT being incurred on these costs. The operating cost budget for the first year of trading, 2018/19, has been approved (taking into account irrecoverable VAT and company profits). The costs are higher than anticipated at the time of the Autumn 2017 progress report, and those reflected in the Pool's initial Cost Savings Model.

More clarity on the necessary costs of building a regulatory compliant asset management company together with the "lived experience" of the LGPS Central Ltd senior management team identified additional costs. Also, the MiFID II regulations requiring the unbundling of investment research costs were responsible for a £0.7m increase in the operating budget; it should be noted that Partner Funds will benefit from a commensurate reduction in investment transaction costs. The Partner Funds undertook a rigorous due diligence exercise on the proposed operating budget, which involved the comprehensive analysis of the Operator's proposed items of expenditure and a series of robust negotiations with the Company's senior management team.

LGPS Central Ltd will put in place strong financial controls to ensure that all expenditure is necessary and that value-for-money is achieved. Budgets and forecasts will be under particularly close review during the first year as the Operator seeks to build out services and infrastructure to deliver appropriate solutions to the Partner Funds.

The Partner Funds collectively achieved significant cost savings between 2014/15 and 2016/17. Total Investment Management Expenses fell from £196m in 2014/15 to £181m in 2016/17, an absolute reduction of £15m. The Total Expense Ratio (TER) fell from 58.0

basis points (bps) to 43.7bps, a reduction of 14.3bps. On a Quantitative Change basis (i.e. applying the 2014/15 TERs to total assets at 31st March 2017 and comparing the resulting number to the actual level of fees paid), Total Investment Management Expenses fell by approximately £47m, partly reflecting the strong growth in assets under management.

Total Investment Management Expenses for 2017/18 have yet to be finalised. As part of the process of quantifying the Total Investment Management Expenses for 2017/18, an external service provider will be appointed to work with LGPSC and the Partner Funds to ensure that the information provided by the Partner Funds' investment managers is complete, transparent and in line with the Scheme Advisory Board's Code of Transparency. When the Total Investment Management Expenses for 2017/18 have been finalised, the Partner Funds will quantify, and report, the level of cost savings achieved between 31st March 2015 and 31st March 2018 in line with the methodology agreed by the CIPFA Working Group on Post Pool Reporting.

The Pool's initial Cost Savings Model (the Model) was based on assets under management at 31st March 2016 and the opening TERs forecast for March 18 were based on 2015/16 TERs. Total forecast cumulative cost savings between 1st April 2018 (i.e. the date LGPSC was scheduled to launch its first ACS sub-funds) and 31st March 2034 based on this model are summarised below:

Forecast Cumulative Cost Savings	**£m**
Investment Management Cost Savings	436.2
Implementation Costs	(4.3)
Transition Costs	(49.2)
Service Provider Fees	(61.3)
Operator Running Costs	(101.2)
Other Costs / Savings	27.6
Total Cumulative Cost Savings	**247.8**

The principle driver of savings within the Model is greater purchasing power from increased scale and manager rationalisation. The Model also assumes savings from the transition of less liquid assets into the Other Collective Investment Vehicles.

The Model forecasts that the LGPS Central Pool will break even in 2024/25. It should be noted that there is a wide dispersion of forecast cost savings between the Partner Funds, with marginal savings forecast for several Funds within the Pool.

The Partner Funds and LGPSC plan to update the Model in Q2 2018/19 to reflect:

1. Actual Assets Under Management at 31 March 2018;
2. Actual TERs for 2017/18;
3. The most up-to-date estimate of LGPSC product offering, transition timetable and expected TERs; and
4. Updated Operator budgets in respect of governance and running costs.

All other things being equal, the increase in the operating cost budget noted earlier would reduce the initial assessment of the cumulative cost savings between 2018/19 and 2033/34. LGPSC are seeking to identify measures to mitigate this impact on the cost savings and these will be reflected in the updated Model.

As part of the update, the Partner Funds and LGPSC are developing a framework for quantifying the actual cost savings achieved by LGPSC against the forecast savings. The quantification of the cost savings will be in line with the methodology agreed by the CIPFA Working Group on Post Pool Reporting. The framework will also include an assessment of LGPSC's performance against its wider objectives, and any other identified benefits of pooling (e.g. providing a range of asset classes to support the asset allocation strategy of Partner Funds; the sustainability of a larger internal investment team; enhanced levels of corporate governance; responsible investment and engagement, etc.). Whilst these objectives and other benefits are more qualitative and intangible in nature than actual quantifiable cost savings, they are nevertheless important to both Partner Funds and LGPSC.

The Partner Funds and LGPSC plan to be fully transparent in respect of reporting transition costs, the fees and net performance of each asset class and the delivery of cost savings and other benefits against those forecast.

The transition of Partner Fund assets into the pooled products offered by LGPSC will, to the extent necessary, be managed by external specialist transition managers to minimise the overall cost of transition wherever possible. These managers will be selected from the LGPS Transition Framework Agreement. The external transition managers will be required to report the transition costs on a fully transparent basis, and these will be reported to, and be monitored by, the Partner Funds, the Practitioners' Advisory Forum and the Joint Committee.

LGPSC will be fully transparent in respect of all costs in line with the Scheme Advisory Board's Code of Transparency, and will expect the same high standards from external investment managers. LGPSC also plans to share data with the relevant independent cost benchmarking surveys, and actively participate in, and promote the cost transparency agenda.

In due course, LGPSC will publish details of its gross and net performance in each asset class on its website, with comparison against an appropriate benchmark for the listed asset classes; subject to appropriate consideration of commercial confidentiality and FCA compliance requirements. There will also be a link from the websites of the Partner Funds to the LGPSC website once developed. In addition to monitoring by the respective Partner Funds, the gross and net performance in each asset class will be reported to, and be monitored by, the Practitioners' Advisory Forum and the Joint Committee. This monitoring process will be supported, where required, by independent performance and cost benchmarking reviews commissioned by the Partner Funds.

Criterion D: Infrastructure

The Partner Funds had a collective committed allocation to infrastructure of £1.5bn or 3.2% of total assets at 31 December 2017. The Partner Funds have committed a further £330m to infrastructure assets in Q1 2018, and the collective ambition of the Partner Funds is to increase the target allocation to at least 5% over the next few years.

The values noted above only relate to the Partner Funds formal allocation to infrastructure. Partner Funds have other investments in infrastructure assets outside of these allocations in areas such as equities, bonds, property, private equity and private debt.

LGPSC has appointed an Investment Director for Infrastructure and Property and is looking to build the team out further in this area to support the ambitions of the Partner Funds to increase strategic exposure to the area of infrastructure in particular. The Investment Director is already in dialogue with the individual Partner Funds to assess their requirements in order to develop appropriate pooling vehicles for infrastructure and property. This remains the preferred investment vehicle for partner funds who are working with the company to develop the offer.

In the meantime, Partner Funds are continuing with their individual investment programmes and will continue to invest where they identify investments that meet their strategic and financial return objectives. The Partner Funds' Investment Working Group will also ensure that within the Pool there is wider discussion on potential infrastructure investments and that all Funds are aware of potential opportunities. Consideration is being given to whether there is an opportunity to explore local opportunities in both infrastructure and housing, within the wider LGPS Central region where there are financial and economic benefits from doing so, but only if these meet the same stringent financial objectives as other investment opportunities.

Some collaborative working has already taken place within the Pool on a residential housing related investment, where four of the LGPS Central Partner Funds, together with another LGPS Fund, collaborated on due diligence resulting in a co-ordinated investment across Central's Partner Funds of £90m.

The Investment Director, Infrastructure and Property is part of the wider LGPS Cross Pools Infrastructure Working Group and at least one Partner Fund representative also attends this group to ensure there is full coverage of opportunities to collaborate across the LGPS Pools. Opportunities for wider collaboration between investment pools are also being explored to maximise the benefits from collaboration and economies of scale.