NORTHERN TRUST

THE LOCAL GOVERNMENT PENSION SCHEME: BEYOND ASSET POOLING

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The local authority pension funds of England and Wales have pooled their assets into eight separate pools to achieve greater investment economies of scale, collective negotiating power and access to resources. Northern Trust looks beyond the process of asset pooling and the formation of the pools to the changes, challenges and opportunities that come next.

IN THIS PAPER:

Key challenges and opportunities for LGPS funds and their asset pools:

- Discharging shared responsibilities
- Governance and oversight
- Data and transparency
- Alternative investments
- Leveraging purchasing power

EXECUTIVE SUMMARY

Discharging shared responsibilities: where the pools and their underlying LGPS pension funds share responsibilities, they will need to agree on the division of these amongst themselves, the levels of required reporting detail and the corresponding processes.

Governance and oversight: Despite the significant scale of this exercise, the day-to-day responsibilities of many people overseeing LGPS funds will largely remain the same. New mechanisms may be required to guide their relationships with the pools and they should ensure risk management practices continue to be robust.

Data and transparency: Those who oversee LGPS funds should consider how much investment data is needed to maintain required levels of oversight. They should consider how their pools will generate statements and ensure high-quality data is sent to stakeholders and regulators.

Alternative investments: Varying approaches will be taken to drive efficiency across LGPS funds' allocations to alternatives. Consideration should be given to the processes, systems and investment operations needed to support these approaches and deliver accurate, transparent and timely reporting.

Leveraging purchasing power: the LGPS will face more pressure than other institutional investors to make wider, positive societal contributions. There will be opportunities to achieve this through its enhanced investment scale and purchasing power.

BEYOND ASSET POOLING

This year, more than 5.3 million members of the LGPS, one of the largest public-sector-backed defined benefit systems in the world, saw management of their retirement assets change.[1]

In what is likely one of the most significant pooling exercises ever undertaken, the local authority pension funds of England and Wales, with current assets under management of more than £260 billion,[2] are merging their assets into eight separate pools.

The end goal is to realise long-term structural benefits for these schemes and ensure stable pension provision for members. To achieve this, the pools will be responsible for, among other areas, manager selection and implementation of investments for their underlying pension funds.

Although bigger will – no doubt – be better for achieving greater investment economies of scale, negotiating power and ensuring access to resources, significant changes and opportunities lie ahead.

THE LGPS AND ASSET POOLING: A BRIEF HISTORY

In recent years, organisations have become increasingly aware of the potential benefits of pooling pension fund assets into a single collective investment vehicle.

Multinational corporations were among the first institutions to pool pension scheme assets to gain greater cost efficiency, purchasing power and risk control of investments. Many sponsors have seen these benefits contribute to reducing deficits, increasing retirement provisions and navigating an increasingly uncertain investment environment.

The UK government launched a consultation process in 2014 to reform the LGPS. The logic was clear. Pooling underlying funds into larger vehicles would increase efficiencies and deliver significant cost savings. The government estimated pooling could save up to £660 million per year.[4] It also sought to increase opportunities for LGPS to access best-in-class investment expertise and facilitate exchange of ideas and best practice between the public and private sectors.

The government announced its decision to compel local authorities of England and Wales to pool their assets in July 2015. It also laid out broad criteria for how pooling should operate later that year.[5]

The 91 funds[6] worked together to select suitable partners for each pool and collectively outline their planned approaches. By spring 2018, the transitioning of remaining assets was to begin from the underlying LGPS funds to the new structures.

Even after that transition is complete, the local authority funds will remain in charge of many core functions – in particular, making strategic asset allocation decisions. They will also continue to be responsible for their pension liabilities.

These underlying LGPS funds continue to have an overriding duty to their members. They are stakeholders in the pools, but must also demonstrate their ability to meet standards of governance and oversight.

LGPS ASSET POOLING: TIMELINE

May 2014 – UK government announces its process to reform the LGPS

July 2015 – UK government announces its intention to pool LGPS assets

November 2015 – UK government publishes investment reform criteria and pooling guidance

July 2016 – Eight pools submit their detailed proposals to the government

April 2018 – Deadline for most individual funds to start transferring their liquid assets into pools

LOOKING BEYOND ASSET POOLING

As all the pools become operational, many changes lie ahead. The pension schemes and pools themselves will be moving into exciting but uncharted territory. The sheer scale and scope of the transition—as well as its cultural impact—should not be understated.

While much has been written about setup of the pools themselves, it is important to remember the underlying LGPS pension funds will remain responsible for liability management and investment strategy and asset allocation decisions.

This raises interesting questions for the sector: how might arrangements be managed between individual funds and the pools? What should each of their priorities be? How should the underlying funds engage with their pools while retaining their independence? How can all parties work together to deliver outcomes that match the scale of their ambitions?

SCOTLAND AND NORTHERN IRELAND

- The LGPS funds of Northern Ireland and Scotland were exempt from this round of asset pooling.
- However, the Scottish government and its 11 LGPS funds are consulting on how they may best work to increase their efficiencies and purchasing power[3].

THE LGPS ASSET POOLS: VARYING APPROACHES, COMMON CHALLENGES

Reaching this point has required widespread collaboration among the pools, their underlying pension funds and service providers. But as theory increasingly moves to practice, it is only natural to expect further adjustment of operational models, processes and practices across the LGPS.

As a result of the varying characteristics of the eight pools, adjustments will occur at the individual levels of each entity. All are different – they are the result of collaboration among their underlying funds. Each has varying ideas, and has adopted different approaches. And while some have only recently begun to transition assets, others have been operational for several years.

The pools use a variety of approaches to implement their investment operations. Most use the UK Authorised Contractual Scheme (ACS) fund vehicle. Of those using an ACS, some have set up their own investment structures – essentially building an in-house operating company from scratch. Others have chosen to rent an ACS operator rather than develop in-house capacity to build one.[7] In this latter approach, the operator assumes responsibility for operating the scheme and investing participants' funds.

The UK Authorised Contractual Scheme:

- A fund vehicle introduced in 2013 to introduce a structure that aligns with other European tax-transparent funds.
- The first UK-authorised tax-transparent fund, designed to meet the challenges of cost pressures, distribution and regulatory change.
- Provides more certain positive tax treatment for users when investing cross-border and engaging with overseas tax authorities.
- Regulated by the UK Financial Conduct Authority (FCA).

TABLE 1: THE LGPS ASSET POOLS: AN OVERVIEW[8]

Pool	Participating LGPS Funds	Total Assets
ACCESS Pool	Cambridgeshire, East Sussex, Essex, Hampshire, Hertfordshire, Isle of Wight, Kent, Norfolk, Northamptonshire, Suffolk, and West Sussex	£40.8 billion
Border to Coast Pensions Partnership	Bedfordshire, Cumbria, Durham, East Riding, Lincolnshire, North Yorkshire, Northumberland, South Yorkshire, Surrey, Teeside, Tyne & Wear, and Warwickshire	£43.7 billion
Brunel Pensions Partnership	Avon, Buckinghamshire, Cornwall, Devon, Dorset, Environment Agency Pension Fund, Gloucester, Somerset, Wiltshire, and Oxfordshire	£27.4 billion
Central Pool	Cheshire, Derbyshire, Leicestershire, Nottinghamshire, Shropshire, Staffordshire, West Midlands, West Midlands Integrated Transport Authority and Worcestershire	£41.9 billion
London CIV	Thirty-two London boroughs including the City of London Corporation	£34.5 billion
Local Pensions Partnership	Berkshire, Lancashire and London Pension Funds Authority	£14.5 billion
Northern Pool	Greater Manchester, Merseyside, and West Yorkshire	£42.1 billion
Wales Pension Partnership	Cardiff and Vale of Glamorgan, Clwyd, Carmarthenshire, Dyfed, Flintshire, Greater Gwent (Torfaen), Gwynedd, Powys, Rhondda Cynon Taff, City and County of Swansea.	£16 billion

Whatever the structures used, certain responsibilities will remain at the level of the underlying LGPS funds, and others will be passed on to their pools. And there will also be overlapping areas of responsibility.

THE LGPS FUNDS AND THE POOLS: DISCHARGING SHARED RESPONSIBILITIES

In addition to assuming investment management responsibilities formerly carried out by the LGPS schemes, most pools will share several specific responsibilities jointly with their supporting schemes. These may include the monitoring of their service providers, measuring investment performance and tendering for further services.

Across these areas, the pools and their LGPS schemes will need to establish new processes and systems to deliver these functions. New agreements may be needed regarding services and responsibilities.

Where responsibilities are shared, the pools and their underlying LGPS pension funds will likely need to work together to:

- Agree on the scope, scale and frequency of all required reporting.
- Decide on the any allocation of oversight and reporting responsibilities that may be needed between all parties, and the level of reporting detail required.
- Set up processes suitable for their new environment. For example, decision-making processes in an authorised fund environment will likely be very different to committee-based decision-making.

GOVERNANCE AND OVERSIGHT FOR THE LGPS FUNDS: SAME BUT DIFFERENT?

From the difficulties of generating consistent investment returns to heightened complexity and pressure on governance and risk management systems, the challenges facing today's pension funds are well documented. The LGPS is of course no exception to this, and its underlying schemes will continue to face many of the challenges of other pension funds, even though their assets are now managed by the pools.

In this respect, it is something of a paradox that, while the pooling of its assets is an enormous operational and cultural shift for the LGPS, many of those overseeing local authority pension funds will find that a large part of their day-to-day responsibilities remain the same.

We have mentioned that the underlying LGPS funds will continue making decisions about asset allocation and will be responsible for liability management. Their responsibilities will also continue for fund administration, accounting process management, and attendance of pension board and investment committee meetings. Also, LGPS funds are accustomed to conducting due diligence on their managers; this will continue, but they will also now carry out due diligence on their pools.

Maintaining good governance and control over the assets being invested by the pools will also continue to be of paramount importance for the LGPS funds. In particular, they will need to ensure strong oversight mechanisms exist to guide their relationships with the pools, and must also continue to have robust risk management structures in place.

Each pension scheme will have its own ideas for meeting these challenges, and at the pool level, various mechanisms are being put in place. For example, one pool is setting up a joint committee consisting of one representative from each participating fund.[9] This committee will be responsible for ensuring the pooling arrangements are delivering value for money, meet the needs of individual funds and fairly shares costs.

The underlying LGPS pension funds should consider their changing responsibilities in terms of decision-making as well. How will their day-to-day operations be affected? What are the implications for their relationships with existing counterparties? What effect will the pools' responsibility for investment manager selection have on the underlying pension funds' relationships with investment consultants, accountants or custodians?

DATA AND TRANSPARENCY: HOW MUCH IS ENOUGH?

The underlying LGPS funds should also consider whether they are receiving sufficient operational and investment transparency on issues ranging from performance to compliance reporting. Obtaining sufficient reporting data is central to this. In particular, the underlying LGPS funds should consider whether they are comfortable with the amount of available information about their assets.

This is partly because the switch from segregated accounts to a pooled environment will reduce the level of data readily available as the underlying LGPS funds move from having transaction-level information (on shares that they directly own), to being investors in an asset pool.

DISCHARGING SHARED RESPONSIBILITIES: NEW PROCESSES AND NEW SOLUTIONS?

New processes may need to be established across several areas. For example, consider proxy voting. Here, all parties will need to ensure alignment exists between the pool and its underlying investors in order to ensure clarity and uniformity over how votes will be cast and who will vote on the schemes' behalf.

Questions include: will fund managers be delegating responsibility, or will the pool appoint a single third party to vote? And how will the underlying governance work so that there is no conflict between the parties?

Another example may be seen in relation to Freedom of Information requests, where the LGPS may need to reshape operational processes or implement new ones in order to respond to requests for investment data to which they do not have immediate access.

For some investors, this will lead to a different level of granularity in their investment reporting, which may lead to fresh considerations. How much is needed to maintain required levels of oversight? And how will the pool generate statements and ensure high-quality data is sent to both regulators and stakeholders?

Currently, across the industry, varying approaches exist: some investors are content to only have big picture, high-level information; whereas others require more detailed data on their underlying holdings. This is where 'look-through' asset servicing and data aggregation solutions may be useful to help those overseeing LGPS assets perform their oversight role and discharge their duties.

ALTERNATIVE INVESTMENTS

For most of the pools, their initial focus has been on pooling their LGPS funds' most liquid instruments (e.g. equities and fixed-income assets). Beyond this, the pools and their participating funds are now formulating their approaches for pooling and managing illiquid asset classes, particularly alternative assets such as private equity, property and hedge fund investments.

Several pools and their funds are expected to provide proposals to drive efficiencies for their allocations to alternatives in coming months. Indeed, one pool has suggested that investment costs could fall by as much as 25% as its underlying pension funds move away from investing via fund-of-fund structures and towards co-investing via their pool.[10] Some pools have already outlined plans to build in-house investment teams for their private equity and infrastructure investments[11] and others have made senior appointments to lead their alternative investments.[12]

Over the longer term, approaches to alternatives investing may also include proposals for further potential co-investment between individual pools to further leverage their scale. More innovative ideas and approaches are expected over coming months and years.

Due to their illiquid and opaque nature, alternatives present particular challenges for investors. For example, the systems and processes required for tracking and reporting on alternatives will likely be different to those for more traditional investments.

Investment data may not be readily available for certain asset classes, potentially necessitating specialist data solutions for front, middle or back offices to function smoothly. Sector-specific approaches to accounting and valuation may be required depending on the asset classes involved.

The pools and their LGPS funds should consider the processes, systems and investment operations that will be needed to support these investments, and deliver required levels of accuracy, transparency and timeliness of reporting.

LEVERAGING PURCHASING POWER: DOING GOOD AND DOING WELL?

With the collective purchasing power of more than £260 billion of assets under management, the pools must also consider how to best leverage their investment scale for the broadest possible benefit of their members' interests. Also, due to its government-sponsored status, the LGPS is likely to be under higher pressure to make a wider positive societal contribution than many other institutional investors.

GOVERNANCE CONSIDERATIONS FOR THE LGPS FUNDS:

- How to best work together to achieve consensus in decision-making, and what the best ways are to engage with the new entities?
- Which objectives to set, such as defining what investment 'success' looks like and deciding the data and information required to measure progress towards it?
- Which mechanisms may be put in place to ensure the funds continue to effectively discharge their duties and responsibilities to members?
- How to ensure they continue to retain and demonstrate their independence?
- How to define their responsibilities, in terms of regulatory requirements?
- What is the role of their existing local pension boards?
- How to best structure their oversight model?
- How to engage with other funds making up their pools on a day-to-day basis?

For example, a recent government-commissioned report set out recommendations for 'growing a culture of social impact investing'. It called for the government to increase its participation in co-investments in 'social impact' models, and to identify investment approaches to help tackle social and economic problems.[13]

In this way, the LGPS will almost certainly be required to face the imperative of doing 'good' through its investments, as well as delivering performance and economies of scale. A likely area of discussion is the integration of environmental, social and governance (ESG) issues into investment approaches. Here, the LGPS has a long-standing commitment to responsible investment and of addressing ESG themes.

There are likely to be strong opportunities for this commitment to be further reflected in the greater purchasing power of its investment programme, perhaps following the examples of funds that wish to withdraw[14] or scale back their investments from fossil fuels. Or, to give another example, the LGPS could choose to take a leadership position on corporate governance issues. In this way, many consider that the pools have an opportunity to positively influence wider societal change.

BEYOND ASSET POOLING: SETTING NEW STANDARDS, SEIZING THIS OPPORTUNITY

For everyone working in the LGPS, this process marks the beginning of an exciting new journey. Significant collaboration has taken place over the last four years to bring the pooling of LGPS assets into effect. The achievement is one to be proud of.

The establishment of the eight pools will bring cost savings and efficiencies, and, in time, give pension funds a more powerful voice on key issues that affect its members and its community. But it is early days, and we expect the LGPS to evolve, face new challenges, adjust and find new solutions along the way – as it has always done.

LGPS funds must ensure their independence as well as their influence on the shape and future of the asset pools. By speaking with one voice, there is a significant chance for the LGPS to make a positive and far-reaching difference, set new standards for the pension industry and seize this once-in-a generation opportunity.

NORTHERN TRUST IS COMMITTED TO SUPPORTING THE LOCAL GOVERNMENT PENSION SCHEME

Every day, Northern Trust works with UK pension schemes and remains closely aligned with their evolving requirements – supporting their needs in areas ranging from liquidity management to increasing operational efficiency and providing data solutions for greater transparency and oversight over their assets.

CONTACT US

If you would like to discuss any of the topics outlined in this paper, contact:

CHRIS DULIEU
Head of UK Public Sector
christopher.dulieu@ntrs.com

IAN HAMILTON
Head of LGPS Pooling Initiative
ian.hamilton@ntrs.com

END NOTES

1 *Local government pension scheme funds for England and Wales: 2016 to 2017 (Local Government Finance Statistical Release.* 25 October 2017. Available at: www.gov.uk/

2 Source: Investment & Pensions Europe article: "LGPS: Asset pools (almost) set for action", April 2018 edition; for more details see Table 1 later in this paper.

3 Pensions Age *"Scottish government told to allow LGPS funds to pool assets"*, 24 July 2017

4 Department of Communities and Local Government Consultation Paper *"Local Government Pension Scheme: Opportunity for Collaboration, Cost Savings, and Efficiencies."* May 2014

5 Chris Tambini, Director of Finance and Colin Pratt, Investments Manager, Leicester County Council *"Local Government Pension Scheme – Background and Update on Pooling."* downloaded from www.politics.leics.gov.uk/

6 Participating funds for each pool are listed in Table 1 later in this paper; source: Investment & Pensions Europe article: *"LGPS: Asset pools (almost) set for action"*, April 2018 edition

7 Pensions Expert *"Unchartered Waters: What Lies Ahead for LGPS Pools"* Last Updated: 22 January 2018

8 Asset figures from Investment & Pensions Europe article: *"LGPS: Asset pools (almost) set for action"*, April 2018 edition

9 Kent County Council *"ACESS LGPS Pooling Presentation",* 31 July 2017 downloaded from www.democracy.kent.gov.uk/

10 Investment and Pensions Europe *"UK's Northern pool to go direct in alternatives, targets 25% cost reduction"*, 26 July 2016

11 Financial News, "*UK public pensions target in-house private equity"*, October 26, 2017

12 Professional Pensions *"The Big Read: Where are the LGPS pools three years on?"*, 31 March 2018

13 Investment and Pensions Europe, *"UK social impact investing 'requires flexibility on LGPS pooling"*, 17 November 2017

14 BBC, *"Council Recalls £245m Fossil Fuels Pension Investment"* Last Updated: 8 March 2018

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