Havering
LONDON BOROUGH

PENSIONS COMMITTEE 13 MARCH 2018

Subject Heading:	**London CIV – Consultation on Proposed Strategy**
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Policy context:	In line with Pension Fund's Investment Strategy dated November 2017
Financial summary:	None

The subject matter of this report deals with the following Council Objectives

Communities making Havering	[X]
Places making Havering	[X]
Opportunities making Havering	[X]
Connections making Havering	[X]

SUMMARY

The Governance Review that was commissioned from Willis Towers Watson (WTW) by the London Authorities (LLAs) and the London CIV (LCIV) highlighted a number of issues and indicated a need for the LCIV to both change its governance arrangements and clarify its purpose and future strategy.

As a result, LCIV have initiated a consultation on its future strategy and aims, including a number of proposals on its governance arrangements and longer term strategy. In this paper I set out observations that have been shaped from the broad consensus achieved at the Society of London Treasurers (SLT), and taking account of the seven principles set out by the Local Government Association (LGA).

The key concern is on the LCIV investment options which are not sufficiently granular to allow this and other Funds to implement their strategic asset allocations. This is contrary to the Government's requirement on asset pools and the LGA's seven principles. As strategic asset allocation is crucial to investment performance these proposals create risk to Havering Council taxpayers and to LGPS pensioners of the Fund.

RECOMMENDATIONS

That the Committee:

1. Note and provide comment on the content of this report.

2. Note the Chairman's response to the LCIV questionnaire on their proposals on its governance arrangements and longer term strategy.

REPORT DETAIL

Background

Details of the LCIV consultation proposals were published on 9 February 2018, set out in **Appendix A** of this report and presented at PSJC meeting held on 29 January 2018. The LCIV consultation proposals included a questionnaire for Funds to complete and return by the 28 February 2018. A copy of Havering's response approved by the Chairman is set out in **Appendix B** of this report. The SLT meets on the 2 March to discuss the proposals. All responses will be discussed at the next PSJC on 14 March 2018 and a decision made on the LCIV proposal at Leaders' on 20 March 2018

The LGPS pooling process is continuing to progress with the government deadline of April 2018 for the formal adoption of pooling fast approaching. This Fund has already made good progress with 57% of its assets already transferred to the LCIV. While the LCIV is continuing to develop its range of investment options and internal resources there is some concern over the operation of aims of the LCIV. The WTW Governance Review of the LCIV highlighted a number of issues and indicated a need for the LCIV to both change its governance arrangements and clarify its purpose.

As a result the LCIV has started a consultation on its future strategy and aims, including a number of proposals on its governance arrangements and longer term strategy.

The LGA Principles

- Government will give more time to LCIV to implement a solution provided a direction of travel is agreed prior to May elections.

- Government is adamant that any solution cannot include manager selection at Fund level.

- Government is equally adamant that any solution must include the ability of funds to choose their asset allocation as they see fit.

- It is not true the role of the LCIV is to restrict choice based on its view of effective investment.

- LGPS pools may offer the ability to arrange segregated mandates for an individual (or groups of) funds – but to qualify for pooled status those mandates must be negotiated and managed by the pool company (including the selection of an relationship with the mandate managers) and the assets lodged with the pool custodian.

- If Funds go for choice then they must both understand and be prepared to meet and justify the extra cost of either a wider range of sub funds and/or ability to invest via segregated mandates.

- Transition to the pool can either be via a movement of segregated mandates from the fund to the pool.

Governance and Client Engagement

The following proposals have been made in relation to governance of LCIV.

Shareholder

- A General Meeting of the LCIV will be held twice a year with all 32 shareholders plus a Chair, managed by the LCIV. The meeting is to inform all shareholders on the performance of the LCIV and allow shareholders to exercise their rights under the Shareholders Agreement.

- A new 12 person Shareholders Committee will be formed by a mix of Treasurers and Members. The committee will meet quarterly, will consult on strategy and allow shareholders to raise issues and concerns with the LCIV Board, Chaired by the Chair of the LCIV.

- The London CIV Board is expanded with the addition of the Chair of the General meeting. A treasurer will be an observer. The Board will continue to take decisions in the interests of all shareholders and seek to consult with shareholders before taking critical decisions.

- The Shareholder Agreement is not altered but continues to set out the responsibilities of the various parties. The arrangements are formalised by Terms of Reference of the General Meeting and Shareholders Committee.

Client

- The IAC becomes a forum to share ideas and consult with LLAs, when appropriate.

- The arrangements with LLAs are formalised via a Service Level Agreement (SLA) and, if appropriate, and Investment Management Agreement (IMA).

The SLT have indicated broad support for the majority of the proposals above, however a number wish to see the treasury representative on the Board given equal status, with full voting rights. A number of concerns were raised in the Governance Review with regards to the balance of the Board, and it was felt that giving funds this greater influence in the decision making process would help to build trust with the LCIV.

On the client proposals, there was support for the proposed use of SLAs as this should make the responsibilities of LCIV and the duties they are performing for the Funds much clearer and allow the LCIV to be directly held to account.

The LCIV proposal also states that the individual Responsible Investment (RI) policies cannot be included. The SLT proposed that an overarching RI policy can be agreed for the LCIV, representing a shared minimum requirement for all the parties. Over and above this, a degree of choice and flexibility should be offered for LCIV to enable Funds to tailor their investments in accordance with their own RI approaches. As set out in the LGA's principles it is not the role of the LCIV to restrict choice based on its view of effective investment, it therefore appears reasonable for the pool to provide a certain degree of choice in this matter. However, in determining the range of options available, they must both understand and be prepared to meet and justify any additional costs.

Investments

This is arguably the most controversial and contentious part of the LCIV proposals. The LCIV sets out three flexible investment mandates as follows;

- **Low Cost**: Passive Equity Funds and a Liability Aware fund.

- **Basic:** Blended Investment Mandates established across asset classes with the LLAs selecting fixed amounts in each according to their Strategic Asset Allocation.

- **Enhanced:** Blended and Low Cost Investment Mandates established with LCIV providing tactical asset allocation as opportunities arise. LLAs will be able to tailor the amount of discretion afforded to the LCIV in their individual IMA.

In all cases, funds will retain responsibility for strategic asset allocation whilst the CIV will have responsibility for manager selection, in line with the Regulations. However, it is suggested that the three options will provide flexibility for funds to choose between retaining responsibility for tactical asset allocation, rebalancing and cash management or delegating these options to the CIV.

Concerns

Given the differing funding levels, cash flow requirements, risk appetites and RI policies across the Funds, it is likely that many Funds will look to retain full strategic and tactical asset allocation responsibilities. For these Funds, the proposal recommends the ‘basic’ option, for which LCIV proposes blended investment mandates in each core asset class (e.g. Equity, Fixed Income, Real Assets etc.). However, concerns have been raised that simple blended buckets across core asset classes only will not permit funds to make decisions around issues such as geographical restrictions (e.g. limiting Emerging Markets exposure), cash flow requirements (e.g. equity income) and Responsible Investment (RI) approaches (e.g. low carbon, exclusion policies etc).

Additionally, there are concerns that the use of a single, multi-manager ‘bucket’ for each core asset class is likely to result in the creation of a passive proxy, with active management fees. Funds would prefer to have a range of options available, with varying risk/return profiles and returns net of fees to allow them to make choices tailored to their own targeted risk/return profiles. For example the Havering Fund has multiple objectives on its Fixed Income allocation while the LCIV “Fixed Income blend” would have a single objective.

As such, some funds find it difficult to justify transferring assets to LCIV given that any shortfall in performance will lead to a direct increase in costs for the public purse. It has also been suggested that the CIV’s current cost saving and outperformance targets, of 15bps and 35bps respectively, are insufficiently ambitious, as many funds (including the Havering Fund) currently achieve in excess of 50bps weighted outperformance across their portfolio.

Officers of the Havering Fund have significant concerns over the proposed Enhanced Model. It builds on the points above and effectively extends the remit of the LCIV to a form of fiduciary management with discretion of over strategic asset allocation. Although the discretion could be set in the IMA and be in relatively controlled ranges, this seems to move away from the principle of Funds setting their own strategic asset allocation thereby contradicting the Government’s requirement as set out in the third principle of the LGA above.

The concerns described above all raise the risk that enforcement of the options set out in LCIV’s consultation document will strengthen the case for funds considering procurement outside the CIV, as severely restricted choice for funds could be argued to reduce value for money.

Response

Following discussion, SLT suggests that a fourth mandate option should be proposed to LCIV, to complement the three currently offered. This fourth option would be a ‘Moderate’ approach, to be offered for funds wishing to retain greater strategic and tactical asset allocation responsibilities to help fulfil their investment strategy. It proposes the same principles as the 'Basic' approach but proposes the use of single manager, rather than blended, sub-funds to allow greater flexibility for funds within the 'core' asset classes. For example, equity sub-funds might include focused options (e.g. Emerging markets, high growth or low growth), or an equity income option for funds with greater cash flow requirements.

Although the range of options available to funds would increase, full responsibility for manager selection would rest with the CIV as per the Regulations. Choice for funds would increase, but these choices would be centred around risk/return profiles and returns net of fees.

The moderate approach could also permit greater flexibility around implementation, as single manager strategies could potentially be delivered 'off-ACS', via the use of segregated mandates held with LCIV's custodian. As per the LGA's principles, these mandates would need to be negotiated and managed by the Pool.

The Havering Fund is involved in a couple of collaborative approaches covering its Real Assets Mandate and Private debt Mandate and this Fund's Consultation response and the SLT have asked that these be leveraged in conjunction with the pool to help increase assets considered as pooled, even if these exist outside the ACS structure.

IMPLICATIONS AND RISKS

Financial implications and risks:

Strategic asset allocation is critical to investment performance. The Committee is required to close the funding gap of the Fund and meet the investment growth targets set by the actuary. The LCIV investment proposals are not sufficiently granular to allow this Fund to implement its strategic asset allocation and this is likely to result in higher LGPS contribution rates at future valuations as a consequence. The LCIV blended investment target at 35bps coupled with 15bp savings is relatively modest and are below the investment outperformance targets of the Fund's existing mandates.

The LCIV proposals further remove control that the Committee have over its investments.

Legal implications and risks:

There are significant and detailed legal obligations covering the duties of the pension trustees. Legal and other professional advice is being taken in respect of material issues so as to ensure that the stakeholder interests are protected to best effect.. The committee and officers are aware of their ongoing need for this advice and are taking appropriate steps to have this support.

Human Resources implications and risks:

None arise from this report.

Equalities implications and risks:

There are no equality implications or risks as a result of this report.

BACKGROUND PAPERS

Background Papers List
None