Sackers

Public sector briefing

December 2015

Highlighting the latest developments in public sector pensions

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Abbreviations

ABC: Asset backed contrbution

DCLG: the Department for Communities and Local Government

FCA: Financial Conduct Authority

IA: Investment Association

LGA: Local Government Association

LGPS: Local Government Pension Scheme

MiFID II: Markets in Financial Instruments Directive II

SPV: Special purpose vehicle

TPR: The Pensions Regulator

In this issue

Welcome

"As expected, this year's Autumn Statement included important announcements concerning LGPS investments and, in particular, asset pooling. Busy is the new normal for the LGPS and the proposed timeline for initial responses and implementation will require continued heroic efforts from all involved.

In this briefing, we focus on investment issues for public sector schemes, including some high level thoughts based on our experience of multi-billion pound pension scheme restructurings.

The Autumn Statement also introduced welcome changes to the existing investment regulations, though many may feel that the impact of these changes is rather overshadowed by the pooling proposals.

We also provide an update on the MIFID II proposals which could re-classify LGPS administering authorities as "retail investors".

Finally, we share our practical thoughts on asset backed funding structures – a relatively new development in the public sector but one with potential, in our view.

As ever, we welcome any feedback on this briefing and (at the risk of getting in there a bit early) would like to take this opportunity to wish you a Merry Christmas."

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LGPS: Investment reform criteria and guidance

As promised in the Summer Budget 2015, DCLG has published guidance on its proposals for asset pooling and the Government's aspiration to produce six British Wealth Funds, each with assets of at least £25 billion.

The Cabinet Office and DCLG, in conjunction with PWC, have also published a paper supporting their view that the new vehicles could be established within 18 months. This means that assets could begin to be transferred from existing LGPS funds from April 2018. It does, however, acknowledge that administering authorities hold certain illiquid assets which will not be transferable in that timescale and that these should not be liquidated where it would be disadvantageous to do so.

The LGPS will be used to the Government's curtailed timeframes by now; but even so, they seem ambitious. If our experience with comparable scale restructurings in the private sector is anything to go by, administering authorities will, once again, have their work cut out for them.

Administering authorities need to respond to DCLG with their outline proposals by 19 February 2016, with "refined and completed" submissions expected by 15 July 2016.

The guidance sets out four criteria which administering authorities will need to work through carefully.

1

Asset pools which achieve the benefit of scale

It will be up to the 90 administering authorities to both establish and implement the asset pools as they see fit, each with a value of at least £25 billion. Proposals will be expected to indicate:

- the size of the pools once operational
- whether any assets will sit outside the pool (and explain why)
- how the pools will operate, for example, what will be outsourced and what will be carried out in-house
- timescales for implementation.

2

Strong governance and decision making

Governance will be a key priority. Administering authorities will need to develop appropriate new models based around the pools, taking account of the need to represent each participating authority. Efficient and effective decision making will be essential to good governance.

3

Improved capacity (infrastructure)

Increased infrastructure appears to be a lingering preoccupation for the Government. The guidance confirms that the administering authorities' proposals will be expected to address this explicitly, detailing how infrastructure will feature in authorities' investment strategies and how the pooling arrangements can improve the capacity and capability to invest in this asset class.

4

Reduced costs and excellent value for money

DCLG focuses on management fees and "hidden costs", as well as transparency in reporting. Proposals will be expected to include:

- a fully transparent assessment of investment costs and fees as at 31 March 2013
- a fully transparent assessment of current investment costs and fees (on the same basis as the 2013 comparison)
- a detailed estimate of savings over the next 15 years
- a detailed estimate of implementation costs and when they will arise, including transition costs as assets are migrated into the pool(s), and an explanation of how these costs will be met
- proposals for reporting transparently against their forecast transition costs and savings, as well as how they will report fees and net performance.

LGPS: Investment reform criteria and guidance cont.

Sackers' comment

Having set out, in very high level terms, where it wants to get to and its timescale for arrival, DCLG has made the enormous project of asset pooling the LGPS's problem. All the underlying details have been left for the administering authorities themselves to sort out. And this challenge has been laid on the table next to extensive new powers for DCLG intervention. One might say this is a newly crafted stick for DCLG, with no real carrot for the administering authorities.

It is also unclear whether DCLG's aim to have funds of at least £25 billion will align with current pooling projects around the country. It would be unfortunate if this target size were to become an obstacle to existing and otherwise viable plans.

Multi-billion pound asset transitions and restructurings are not a new phenomenon. Here at Sackers we have advised on numerous substantial projects with similar challenges. The following points will be key.

Project management

Administering authorities will need to have strong project management capabilities. Most, if not all, will already have formulated their proposals to some extent. Much is still to be done and planning and implementation of a project of this size will require skilful and dedicated management. Given the possibility of capacity constraint, forward planning will also be key.

Illiquid assets

Careful review of existing documentation and, in particular, alternative asset holdings will be important. Many administering authorities have extensive alternatives holdings, which are typically only transferrable with manager consent and which may be highly illiquid. Authorities will need to understand what possible stumbling blocks exist before formulating a strategy for dealing with them.

Derivatives

To the extent that administering authorities hold derivatives on a segregated basis, these will also require particular care in transition.

New LGPS Investment Regulations

DCLG is consulting on regulations to replace the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. The draft regulations appear to address, at long last, many of the issues which have been criticised in the current regime. The deadline for responses is 19 February 2016.

Goodbye LGPS limits

The draft regulations would do away with the existing Schedule 1 "headroom" limits which focus on the nature of the asset vehicle rather than any discernible risk analysis. Removing these limits will also remove one of the potential complexities of the new asset pooling proposals. Administering authorities will, however, be required to set out their own maximum percentage of the total value of all investments of fund money that they will invest in particular investments or classes of investment. Authorities may wish to push back on this proposal.

Hello prudential limits

In place of the old limits, it is proposed that administering authorities will need to formulate an investment strategy addressing their approach to the following:

- the requirement to invest fund money in a wide variety of investments
- the suitability of particular investments and types of investments
- the approach to risk, including the way risks are to be measured and managed
- the approach to pooling investments
- social, environmental or corporate governance considerations
- exercise of voting rights.

Although referred to as "prudential" limits, there are significant differences to the provisions which currently govern trust based schemes.

Stay off the naughty list

In setting their limits, administering authorities will need to have regard to DCLG's guidance, including the newly published guidance on pooling (see pages 3 & 4 for details). It is envisaged that the Secretary of State will have emergency powers, to use where it is satisfied that an administering authority is failing to have regard to any of the published guidance. These broadly cast powers would enable the Secretary of State to intervene directly in the authority's investment activities and include powers:

- to make changes to the investment strategy
- to direct the authority to invest in specific assets
- for the Secretary of State to take over the authority's investment powers for an indefinite period.

Before exercising its powers, the Secretary of State would need to "have regard to" such evidence it considers reasonable, including input from the actuary, local pension board and the target authority itself.

Derivatives are go!

The definition "Investment" has long been a source of quiet (or not so quiet) debate among Local Councils in terms of the use of derivative instruments. DCLG has, thankfully, taken the opportunity to recast the provisions to address these points and we will look carefully at the proposed drafting.

MiFID reforms: Impact on LGPS investments

Background to the MiFID reforms

MiFID II is set to amend and replace the original MiFID under reforms to improve investor confidence and increase transparency for both equity and non-equity markets (bonds, structured finance products, derivatives). With investor protection in mind, MiFID II seeks to protect local authorities, among others, from risky investment options and poor decision making. The timetable for controversial new proposals around the classification of administering authorities looks set to be given a reprieve, with implementation likely to be pushed back to 3 January 2018.

LGPS: retail or professional investor?

LGPS administering authorities are classed as "professional clients" for MiFID business and routinely invest on this basis. This classification is essential to gaining access to more complex strategies such as hedge funds, private equity and property.

Changes under MiFID II mean that LGPS authorities will automatically be classed as "retail investors". As such, unless they "opt-up" to professional client status, they will be treated by financial services firms (such as banks, brokers, advisers and fund managers) in the same way as individuals and small businesses. In practice, this is likely to mean more paperwork, more compliance, and restrictions on the type of product they can invest in. As the changes could have a significant impact on LGPS funds' existing portfolios, it is hoped that transitional provisions will be introduced which would prevent the need for a "fire sale" of current holdings.

Electing professional client status

To retain access to a full range of investment options and remain subject to less onerous compliance requirements, LGPS authorities may be able to elect to be treated as professional clients. Broadly, the responsible officer would need to demonstrate to each asset manager that they:

- are capable of making their own investment decisions and understanding the risks involved and
- satisfy two of the following:
  - they have carried out at least 10 transactions in "significant size" on the relevant market per quarter, over the previous four quarters
  - their portfolio (including cash deposits and financial instruments) exceeds EUR 500,000
  - they work, or have worked, in the financial sector for at least one year in a professional position which requires knowledge of the transactions or services envisaged.

Applications must be made in writing and, having received clear written warnings of the protections and investor compensation rights that stand to be lost as a result of electing professional status, the responsible officer would need to confirm that they are aware of the consequences.

Next steps

The FCA has been consulting on areas of MiFID II where it has discretion over implementation in the UK, and its response is awaited. Meanwhile, the LGA, the FCA, DCLG and the IA are looking at ways to lessen the impact of MiFID II on LGPS authorities. In particular, they are investigating:

- the process for electing professional investor status to see if the process can be simplified for local authorities in relation to their pensions functions
- whether a transitional period could be introduced, to avoid a forced sale of assets for those authorities which have not completed election for professional status by the January 2017 deadline.

In the meantime, to avoid disruption to their investment portfolios, LGPS authorities should be looking, as a matter of urgency, at whether they can meet the professional client tests. They should also engage with their asset managers to understand how the tests will be applied in practice.

Five things to know about asset backed contributions

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Already popular in the private sector, there is growing interest in the use of asset backed contributions by public sector pension funds. We take a look at five key things to consider when deciding whether to use an ABC as part of a scheme's funding plans.

What is an asset backed contribution?

An ABC is a structure in which the employer and scheme have an interest. The structure usually involves the use of a special purpose vehicle, most commonly a Scottish limited partnership. The employer places assets into the structure – hence the term "asset-backed". Those assets produce an income stream to the pension scheme and, on certain funding triggers, the scheme can access the assets and realise value from them. The income stream is generally designed to meet the deficit in the pension scheme (on the basis of the statutory funding objective) over an agreed period of time.

What types of assets are used?

The most common type of asset used is property. However, ABCs have been put in place involving a wide range of assets including intellectual property, loan receivables, whisky and ships. The assets are usually sold by the employer (or other members of its corporate group) to the SPV and the employer then pays the SPV to enable it (or the wider group) to continue to use the assets in its business. For example, the payment of rent to use property. Those payments provide an income stream to the SPV, which in turn provides an income stream to the pension scheme.

Employer benefits

An ABC is beneficial from an employer's perspective as it can lower the amount of cash it has to pay into the pension scheme each year when compared with a conventional recovery plan – the lifespan of an ABC is typically between 15 to 25 years which is significantly longer than a cash recovery plan is likely to be. The employer also benefits from an immediate reduction in the pension scheme deficit. The interest in the ABC structure is a scheme asset. Its value – broadly the net present value of the income stream – is therefore taken into account for scheme valuation purposes.

The scheme's perspective

Although cash with always be "king" from a scheme's perspective, an ABC structure can represent a workable compromise solution where an employer has cash constraints. The assets in the ABC are ring-fenced, essentially for the benefit of the scheme, from the remainder of the employer's operations and should have some value in the event of employer insolvency. Administering authorities should bear in mind, however, that these structures are fairly complex and costly to put in place. In addition, the employer-related investment analysis on which they are based has not to date been tested in the courts.

TPR's guidance

TPR published guidance on ABCs in November 2013. In it, TPR recognises that ABCs may help employers to meet their obligations to pension schemes and can, in certain circumstances, improve a scheme's security. However, TPR expects schemes to evaluate any proposed ABC arrangement critically and carefully and to "unpack" the ABC in order to understand the real risks that the pension scheme is exposed to. Administering authorities will generally need to obtain extensive legal, actuarial, asset valuation, investment and covenant advice in order to fully evaluate an ABC and should consider whether there are any feasible alternatives.

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