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Nottinghamshire County Council

Ministry of Housing, Communities & Local Government
Local Government Finance Reform and Pensions,
Local Government Finance 2/SE,
Fry Building, 2 Marsham Street,
London
SW1P 4DF

Dear Sirs,

21 March 2019

RE: Draft MHCLG guidance on LGPS asset pooling - informal consultation

Dear Sirs,

Local Government Pension Scheme - Statutory guidance on asset pooling

The Nottinghamshire County Council Pension Fund would like to thank the Government for recognising the achievement made to date by the eight asset pools across the LGPS. We agree that there is still much to do in terms of the delivery of the pooled vehicle investment offering by the pools and the transition of assets into the pool and therefore, we welcome the statutory guidance to assist us with that challenge, as well as the opportunity to comment on such.

As a Partner Fund of the LGPS Central Pool, we would ask the Government to recognise that, whilst asset pooling is intended to deliver wider benefits as well as cost savings across the LGPS more generally, there are some Partner Funds within the LGPS Central Pool where the cost savings will not be so apparent and transferring assets into pooled vehicles may lead to an increase in costs. We would suggest that the current guidance is extended further to address this risk and provide support and advice to those Partner Funds that may be affected in this way. We would further add that it is important to acknowledge that all decisions about making an investment in a pooled vehicle should continue to be made locally, on a value for money basis, to ensure that these decisions do not run contrary to the fiduciary duty of Elected Members on Pensions Committees, who have a responsibility to act in the best interests of their Pension Fund. It is vital that the guidance reflects this responsibility and provides clarity on requirements in these circumstances.

Our comments on the detail of the statutory guidance follow:

2. Definitions

The definitions are helpful in promoting the use of common terminology and we welcome the clear definition of 'pool governance body' and its role in setting the direction of the pool and holding the pool company to account (4.2).

We do feel that there is further clarity needed around the definition of 'Retained asset' and the reference to the transition period, which we infer to mean until 2020. We feel the transition period should be longer to give realistic opportunity to set up funds and transfer assets. Furthermore this is contra to the concept of the retention of existing assets (5.4, 5.5 and 5.6), including Life funds and direct property which are subject to review at least every three years. This is a reasonable approach for those assets which are not appropriate to transfer, but there is insufficient guidance to judge where this is considered reasonable to be the case.

Likewise, the definition of 'Local assets' and its reference to new investments as opposed to the concept of Local assets (as described in 6.2) which are local initiatives and permitted to be held outside the pool on a permanent basis. Clarification would be helpful.

3. Structure and Scale

3.1 The measurement of 'gross risk adjusted returns' versus what we might otherwise have invested in will be difficult to measure going forward. Strategic Asset Allocations will change going forwards anyway and it will not always be a case of comparing apples with apples. A consistent methodology for calculating risk adjusted returns would be welcomed.

It would be helpful to understand whether Pool members are expected to have full knowledge of all underlying investment manager costs in a Pooled fund / vehicle i.e. full disclosure or if it is acceptable for reporting at the Pooled fund / vehicle level. We feel the latter is sufficient and consistent with other reporting requirements.

It should be recognised that whilst pooling does permit diversification across some asset classes, there is also an element of compromise involved in the specification of pooled funds/ vehicles and pool members are not always going to be able to invest in line with their specific asset allocation requirements.

Also, risk may not always be diversified if the decision is to invest significant assets with one investment manager.

3.2 Confirmation that pool members must appoint a pool company to implement their investment strategies, and that pool companies must be regulated entities is welcomed. This creates a level playing field and a more reliable basis for inter-pool comparison.

The last sentence of 3.2 needs clarification. 'Pool members may continue to decide if they wish to invest via in-house or externally managed vehicles' is contradictory to the previous sentence '…..pool companies to decide ….whether to use in-house or external management. If pool companies are deciding whether to use external or in-house management, how can pool members have the choice of investing internally or externally, unless they do so outside the pool (or invest via another pool)? Whilst there is a general acceptance that in-house management can be delivered more cheaply than external management, this should not be at the risk of 'affecting gross risk-adjusted returns' and therefore unless the internal team has a good performance track record, which is comparable to that of the external managers and one which stands up in an open procurement process, the decision to invest via in-house or via external managers must be retained by pool members and the pool company should offer both options through its pooled vehicles. There should be no automatic blending of both unless agreed by all pool members.

3.6 We are unsure as to why there is specific mention of active and passive management in this guidance as we feel the decision to invest in either should form part of a pool members decision making process in respect of Strategic Asset Allocation (4.2). The expectation of ongoing performance comparison may also prove difficult; some standard methodology for calculating risk adjusted returns has already been referred to.

4. Governance

4.2 Thank you for the emphasis that Strategic Asset Allocation remains the responsibility of pool members in recognition of an authority's specific liability profile and cash-flow needs.

4.4 Whilst we recognise the wider perspective and appreciate the need for a long-term view, one of the original four criteria for asset pooling was focussed on cost savings and value for money. Whilst the implementation costs of pooling can be recovered over a longer timescale, and this may also be true of transition costs in some cases, there needs to be ongoing savings for these costs to be recovered. Therefore, any sense of forcing funds to transfer assets into a pool at increased cost risks undermining the potential cost savings in the long-term.

4.5 & 4.6 Recognising that Local Pension Boards have a role to play in the oversight of the governance of the pool is helpful, as is the flexibility for each pool to decide for themselves whether or not observers drawn from the Local Pension Board are included on pool governance bodies.

4.8 This is somewhat contradictory to 4.2 and would benefit from clarification. Tactical Asset Allocation decisions are typically short-term deviations from a pool members Strategic Asset Allocation and it therefore follows that these decisions should reside with individual pool members.

4.9 We agree that including an explanation of how the balance between the range of pool vehicles and reduced costs is reached is an appropriate thing to include in the Investment Strategy Statement albeit we are not sure it has a place in the Funding Strategy Statement. However, at this point of delivery we are unable to comment fully on this as our priority is the creating of sub-funds and transferring pool members' assets into them so cost savings can be delivered. It may be more appropriate to defer this particular requirement to a later 'business as usual' version of the guidance in due course.

5. Transition of assets to the pool

5.1 Transition of listed assets '…..over a relatively short period' is somewhat vague albeit the fact it is not prescriptive is helpful. However, the guidance should be expanded to recognise that the lead time required to set up FCA regulated sub-funds and transition assets into them will not always be possible over a relatively short period. The nature and objectives of the fund are relevant, not just whether the assets transitioning into them are listed. Whilst time is a factor, it is more important that Pool companies are not pressured into employing excessive resources to speed up implementation in the short term, which may increase total costs above and beyond savings which could be delivered in the longer term. Instead Pools should have criteria for assessing the prioritisation of the creation of new Pool vehicles. In LGPS Central for instance we have a set of 8 agreed criteria to help us determine what makes one sub-fund more important than another; Cost savings and Pool member inclusion being 2 of those criteria.

5.2 / 5.3 We welcome the clarity and permissions around cost-sharing.

5.4 Whilst this is helpful, it might be useful to state that the government recognises that for some investments the time frame for retention may be significant e.g. for Illiquid asset classes such as Private Equity.

5.5 It is helpful to state that life funds, direct property, and some infrastructure investments may remain outside the Pool where the costs of transitioning could be significant. However, this should be extended to recognise that it should also explicitly apply where the costs of managing any investments would be higher within a Pool fund or vehicle. This decision would form part of the Regular review of retained assets at least every three years (5.6) with the rationale for such a decision being clearly stated. This one change would go a long way to meeting our concerns over potential conflicts between our fiduciary responsibilities and statements in the guidance requiring the transition of assets.

The ability to retain existing direct property assets outside the pool is also welcomed, given the potential costs of changing ownership (unless there is legislation to exempt funds from much of this). However, the government is asked to recognise that these assets will continue to need active investment management in order that the property portfolio remains fit for purpose in terms of delivering income, capital growth and investment returns. Pool members must have the ability to re-shape their retained direct property portfolios in line with the market. This mitigates the risk of sub-optimal portfolios that simply cost money and result in a drag on performance i.e. the need to continue to buy, sell and undertake capital expenditure for development. (This ties in with 6.4). In time Pool companies will provide appropriate Pool funds and vehicles for direct (and indirect property) which, in the first instance will be available for new/ additional Strategic Asset Allocations to property or for the unwinding of the costlier indirect vehicles. Again, these will need to be actively managed to avoid the same sub-optimal portfolio risks.

6. Making investments outside the pool

6.1 Whilst we are committed to being ambitious, we are realistic in our expectations that it will be extremely difficult for Pool companies to offer an adequate range of investment vehicles by 2020. Consideration should be given to extending this date rather than setting unachievable targets.

6.2 See previous comment in Definitions regards Local assets.

6.4 Pool companies clearly need to be encouraged to offer the investment products that pool members need to deliver their investment strategy. However, this may not always be possible, and it should be acknowledged that in some instances holding assets outside the pool and/or making new investments outside the pool will be the only alternative; particularly where the provisions of 6.2 and 6.3 cannot be utilised.

7. Infrastructure Investment

The adoption of the CIPFA definition of Infrastructure is welcomed as is the flexibility in respect of targets and methods of delivery.

8. Reporting

Given that the results of the CIPFA consultation are not yet available, albeit they may be effective from 1 April 2019, and given that the closing date for this consultation is not until 29 March 2019, we anticipate that additional review for the purposes of alignment may be necessary.

Whilst we acknowledge the drive for fairer comparison across LGPS funds and pools, a great deal of information is being asked for across this Reporting section and at this stage, it is difficult to know what may or may not be readily available or easily accessible. The potential for additional resource requirements to manage increased levels of reporting across pools and within Pool member funds should also be recognised.

8.2 See previous comments in Definitions in respect of ‘retained assets’ and ‘local assets’. The reference to ‘transition plans for local assets’ would seem to be more appropriate for ‘retained assets’ i.e. ‘an existing investment retained by a pool member during the transition period’. A ‘local asset’ (2.1) is ‘a new investment by a pool member which is not a pooled asset’ – which in accordance with 6.1 and 6.2 are likely to be held outside the pool on a more permanent basis.

8.5 It is implicit that there may not be a specific end date for some assets being held outside the pool (5.5) and a high-level transition plan may not be appropriate. In these instances, being able to provide the rationale and cost implication of comparable pool vehicles together with the next review date should suffice.

In conclusion, we would like to reiterate our thanks for this guidance and for the opportunity to comment. There are a few anomalies identified and a number of areas where greater clarity would assist and not lead to wider misinterpretation, but we accept that we are all still progressing through a period of learning and there may be a need for more regular ‘business as usual’ updates to this guidance as we continue our LGPS pooling journey.

Yours faithfully,

Nottinghamshire County Council Pension Fund