

Croydon Council

REPORT TO:	PENSION COMMITTEE 6 December 2016
AGENDA ITEM:	7
SUBJECT:	Developments to the Regulatory Framework for the Local Government Pension Scheme.
LEAD OFFICER:	Richard Simpson Executive Director of Resources
CABINET MEMBER	Councillor Simon Hall Cabinet Member for Finance and Treasury
WARDS:	All
CORPORATE PRIORITY/POLICY CONTEXT: Sound Financial Management: The Pensions Committee is responsible for providing guidance for the effective administration of the Pension Fund and hence needs to be kept abreast of any developments relating to that function.	
FINANCIAL SUMMARY: There are significant financial implications relating to these proposed changes and with this the risk that these changes will reflect on the costs to the Council's overall finances.	
FORWARD PLAN KEY DECISION REFERENCE NO.: N/A	

1 RECOMMENDATIONS
1.1 The Committee is asked to note the changes outlined in the body of the report.

2 EXECUTIVE SUMMARY

- 2.1 This report provides a summary of the key proposals that are in the pipeline so far as they will impact on the administration of the Local Government Pension Scheme.

3 DETAIL

- 3.1 Despite assurances that the introduction of the New Look Local Government Pension Scheme (LGPS) in 2014 was to represent a generational reform, there are a number of additional changes to the Scheme due over forthcoming months and years. Many of these changes have the potential to fundamentally change the character of the Scheme.

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (SI 2016 No. 946).

- 3.2 On 23 September 2016, new Regulations affecting the management and investment of Local Government Pension Scheme (LGPS) funds in England and Wales were laid before Parliament. The Regulations will dispense with the current, explicit limits on specified types of investment and, instead, charge administering authorities with determining the appropriate mix of investments for their funds according to a Prudential Framework approach, such as applies to the affordability of the Council's capital investment programme. The quid pro quo for more freedom in the formulation of investment strategies is an obligation upon administering authorities to adhere to official guidance and broad powers allowing the Government to intervene if they do not.
- 3.3 At the time of drafting this report the revised regulations had not been enabled due to the tabling of an Early Day Motion debate. Once enacted though, barriers to investing into LGPS Regional Pools would be lifted.
- 3.4 The Regulations were due to come into force on 1 November 2016 and require administering authorities to publish an Investment Strategy Statement (ISS) before 1 April 2017 in accordance with these new rules. The Department for Communities and Local Government (DCLG) had already, on 15 September 2016, taken the rather unusual step of publishing its statutory guidance—before the Regulations became law. Effective dates aside, the legislation is all but identical to the draft version that was circulated for consultation purposes in November 2015.
- 3.5 The new ISS must be formulated in accordance with the Government's guidance, and having first obtained suitable advice and consulted appropriately. That strategy will have to include:
- a requirement to invest in a wide variety of investments (the Regulations' definition of an 'investment' is broad but makes explicit reference to derivatives, thereby removing an ambiguity which had prevailed for some time);
 - an assessment of the suitability of particular investments and investment types (it must also state the maximum proportion of its fund that it will invest in particular investments or investment classes);
 - the authority's attitude to risk, and how it will be assessed and managed;

- its approach to investment pooling;
- how it takes account of social, environmental and corporate governance factors; and
- its policy on exercising voting and other rights attached to investments.

3.6 Croydon, as the administering authority, will have to publish the first such ISS by 1 April 2017, and maintain it with reviews taking place at least triennially.

Academisation and the Local Government Pension Scheme

3.7 The LGPS Scheme Advisory Board (SAB) is appointing an advisor to “assist it in developing options with regard to the plan to convert all schools to academies and what this will mean for LGPS pension funds and their host authorities”. The SAB say that this will lead to them “potentially making recommendations to the Secretary of State”. The work required is to:

- “investigate the implications for the LGPS of a significant increase in academy employers,
- “develop options to manage those implications for consideration by the Board,
- “cover the administrative, actuarial, legal and investment issues.”

3.8 There is speculation that this project could recommend a number of options which could include:

- Mandating contribution rates and/or the contribution-setting approach for academies in LGPS funds. This would certainly bring greater consistency between academies. However, This could see some academies over- or under-paying in reality, by following the prescribed route whilst other employers are treated unfairly, that is to say if academies are able to water down their pension contributions then why cannot local authorities, charities and housing associations, for instance.
- Moving academies into a few (or even a single) LGPS fund. Clearly this would help ensure consistency of approach between academies. However, ceding funds would see a sudden and significant worsening of their cashflow and maturity profile, potentially leading to forced disinvestment in the short term and a need to review asset allocation (with less emphasis on growth assets and more on income producing assets). The receiving fund on the other hand would likely be significantly cashflow positive, buying assets whilst other funds disinvest. Overall costs across the LGPS could increase. There would also be significant administrative costs to implement transfers, together with the ongoing costs of managing these as and when further schools convert to academy status not to mention the increase in officer support and other resource in the receiving fund.
- Removing the obligation on academies to put non-teaching staff in the LGPS would not address the immediate funding issues, and indeed would be largely a case of “closing the door after the horse has bolted”: the variations in contribution rates mainly arise due to historic deficits, not due to future benefits being earned by those staff and new entrants.
- De-funding the non-teaching staff pension obligations looks like the “Royal Mail type” approach which was widely criticised at the time for its short-term view of pension obligations. In the long term the several £billions of academies’ pension obligations

will still have to be met and would put strain on central Government finances. For LGPS funds, the removal of academies' staff would precipitate the cashflow and maturity issues mentioned earlier.

- 3.9 None of the new ideas on how to deal with academies deals fully with all of the issues cited by academies and some bring a whole new set of problems.

Fair Deal

- 3.10 The new Regulations extend admitted body status for protected employees but Higher and Further Education Colleges are excluded as are Primary Care Commissioners. The full costs of LGPS arrangements must now be stated in tender documents and an exit payment will be required if there is a shortfall at the end of a contract, suggesting that arrangements to cover off these costs in advance will be more useful. The Regulations also extend the requirement for bond or parent guarantee to small employers which will cause some difficulties for many small employers.

Exit Payments

- 3.11 Members will recall Government proposals designed to limit exit payments to senior local authority staff. At the start of the year the Government issued a consultation on possible reforms to early exit payments across the public sector. Its recent response confirmed the Government's commitment to restrict public sector exit costs, establish guidelines for a common framework and set a timeline for reform up to the end of June 2017. This consultation and response is one of a number of strands the Government is currently exploring.
- 3.12 Before the end of the calendar year the Government should publish new Regulations to cover staff who earn over £80,000 and who return to work in the public sector within 12 months of leaving their current employer relating to the calculation of clawback, which will include pension strain costs. Draft regulations are also expected, at around the same date, to cap exit payments, including pension strain costs (but with a possible waiver under certain, strictly defined circumstances) to £95,000. Finally a further consultation is expected on a proposal to cap benefit entitlement calculations to a salary of no more than £80,000 with the removal of the power to pay pension strain costs. These three controls would be overlapping, that is to say two or all might be applied to the same individual.

Financial Conduct Authority (FCA) Consultation: Markets in Financial Instruments Directive II ('MiFID II') implementation proposals

- 3.13 The FCA is currently consulting on implementation proposals for MiFID II which are due to take effect from 3 January 2018. The Markets in Financial Instruments Directive ('MiFID'), part of the European Commission's Financial Services Action Plan, is legislation for the regulation of investment services within the European Economic Area which came into force in November 2007. The MiFID I Directive replaced the Investment Services Directive. It was designed to:

- Achieve harmonisation throughout the economic area
- Aid transparency
- Protect investors

- Improve efficiency
- Increase competition

- 3.14 The European Commission instigated a review of the directive due to increasing complexity of financial products and issues related to the 2008 financial crisis. The outcome of the review was a revised Directive, MiFID II. The Financial Conduct Authority ('FCA') is now consulting on its third set of implementation proposals for MiFID II, which are due to take effect from 3 January 2018. The proposed changes will have a significant impact on LGPS administering authorities.
- 3.15 The main issue that administering authorities could face is a re-classification from 'per se professional' to 'retail' client status. If no action were taken, administering authorities could see restrictions as retail clients e.g. in terms of the universe of investment funds they may invest in. Administering authorities may have the opportunity to "opt-up" to 'elective professional client', i.e. professional client status. The FCA believes that the ability to access financial markets will not be fundamentally affected by broader changes if classified as a professional client. The specific procedure for opting-up will include both qualitative and quantitative assessments.
- 3.16 The qualitative assessment will require: "adequate assessment of the expertise, experience and knowledge of the client that gives reasonable assurance, in light of the nature of the transactions or services envisaged, that the client is capable of making his own investment decisions and understanding the risks involved". Administering authorities will, however, need to have sufficient evidence to demonstrate that the qualitative assessment is satisfied.
- 3.17 Quantitative test a), below and one of b) or c) must also be satisfied:
- a) the size of the client's financial instrument portfolio, defined as including cash deposits and financial instruments, exceeds £15m;
 - b) the client has carried out transactions, in significant size, on the relevant market at an average frequency of 10 per quarter over the previous four quarters;
 - c) the client works or has worked in the financial sector for at least one year in a professional position, which requires knowledge of the transactions or services envisaged.
- 3.18 The size of the Croydon Pension Fund, applying to criteria a) is not likely to present an issue. Criteria b) will present a major issue for the majority of administering authorities, with quarterly transaction activity typically not close to this level. Therefore, reliance will need to be placed on the remaining test to ensure an administering authority can consider opting-up to professional client status. It is not entirely clear how changes in team should be reflected in criteria c). For example, it may be possible that the qualitative assessment will need to be re-run each time there is a material personnel change.
- 3.19 Relationships between administering authorities, pools, asset managers and other providers should be identified so that the impact of the proposed changes can be considered in more detail. Officers have started the process of engagement with asset managers and the London Collective Investment Vehicle (the London CIV).

4 CONSULTATION

- 4.1 Officers have fully consulted with the Pension Fund's advisers in preparing this report.

5 FINANCIAL CONSIDERATIONS

- 5.1 This report considers a number of prospective changes to the LGPS. Additional costs may impact upon the revenues of the Council but the Committee will be updated as and when these provisions are enacted.

6 COMMENTS OF THE COUNCIL SOLICITOR AND MONITORING OFFICER

- 6.1 The Acting Council Solicitor comments that there are no additional legal implications arising by virtue of the recommendations in this report beyond those highlighted within the body of the report.
- 6.2 (Approved for and on behalf of Jacqueline Harris-Baker, Acting Council Solicitor and Acting Monitoring Officer.)

7 FREEDOM OF INFORMATION/DATA PROTECTION CONSIDERATIONS

- 7.1 This report does not contain any information which will not be made publically available by being published on the Council's Pension Fund website.

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