Public Document Pack

Merton Council

Cabinet Agenda

Membership

Councillors:

Stephen Alambritis (Chair)
Mark Allison
Nick Draper
Andrew Judge
Linda Kirby
Edith Macauley
Maxi Martin
Martin Whelton
Judy Saunders

Date: **Wednesday 23 April 2014**

Time: **19:15**

Venue: **Committee rooms B, C & D - Merton Civic Centre, London Road, Morden SM4 5DX**

This is a public meeting and attendance by the public is encouraged and welcomed. For more information about the agenda please contact democratic.services@merton.gov.uk or telephone 020 8545 3361.

All Press contacts: press@merton.gov.uk, 020 8545 3181

Cabinet Agenda
23 April 2014

1.	Apologies for absence	
2.	Declarations of pecuniary interest	
3.	Minutes of the previous meeting	1 - 8
4.	Pension Fund Collective Investment Vehicle for London Councils	9 - 44
5.	Exclusion of the public To RESOLVE that the public are excluded from the meeting during consideration of the following report(s) on the grounds that it is (they are) exempt from disclosure for the reasons stated in the report(s).	
6.	Singlegate Primary School Expansion - approval to award construction contract	

N.B
The Chair of the Overview & Scrutiny Commission, has confirmed that as defined under Part 4B, Paragraph 17 that:

- this Cabinet report in relation to the Singlegate construction Contract report qualifies for exemption as it contains information relating to the financial affairs of any particular person (including the authority holding that information), in accordance with the provisions of Part 4B, Paragraph 10.4 and Category 3 of the Constitution set out, and;

- that it not been practicable to advertise this item for the set 28 days prior to the decision being required to be taken.

Note on declarations of interest

Members are advised to declare any Disclosable Pecuniary Interest in any matter to be considered at the meeting. If a pecuniary interest is declared they should withdraw from the meeting room during the whole of the consideration of that mater and must not participate in any vote on that matter. If members consider they should not participate because of a non-pecuniary interest which may give rise to a perception of bias, they should declare this, .withdraw and not participate in consideration of the item. For further advice please speak with the Assistant Director of Corporate Governance.

This page is intentionally left blank

CABINET
10 MARCH 2014

(19.15 - 19.51)

PRESENT	Councillor Stephen Alambritis (in the Chair), Councillor Mark Allison, Councillor Nick Draper, Councillor Andrew Judge, Councillor Linda Kirby, Councillor Edith Macauley, Councillor Maxi Martin, Councillor Martin Whelton and Councillor Judy Saunders Ged Curran (Chief Executive), Paul Evans (Assistant Director of Corporate Governance), Caroline Holland (Director of Corporate Services), Chris Lee (Director of Environment and Regeneration), Yvette Stanley (Director of Children, Schools and Families), Simon Williams (Director of Community and Housing), and Chris Pedlow (Senior Democratic Services Officer).
ALSO PRESENT	Councillors Suzanne Evans and Henry Nelless

1. APOLOGIES FOR ABSENCE (Agenda Item 1)

There were no apologies for absence.

2. DECLARATIONS OF PECUNIARY INTEREST (Agenda Item 2)

No pecuniary declarations were made.

Councillor Whelton asked that it be recorded, although it was not a pecuniary interest, that as he was Member of the Mitcham Common Conservators, he would be leave the room for the discussion on Item 8, Allocation of S.106 Monies Mitcham Common Conservators.

3. MINUTES OF THE PREVIOUS MEETING (Agenda Item 3)

That the Minutes of the meeting held on 17 February 2014 are agreed as a correct record.

4. BETTER CARE FUND PLAN (Agenda Item 4)

The Cabinet Member for Adult Social Care and Health presented the report, stating the Better Care Fund aim was to provide the opportunity to change local services by integrating some existing funding streams so that people receive more integrated care and support in community settings. It was noted that the overall objectives was to provide protection for social care services and to support local transformation of services so that more people were supported in the community were receiving integrated health and social care services.

The Fund's budget was £12.198million for 2015/16 which had achieved through either existing Department of Health grants or through Clinical Commissioning Group funding already commissioning services.

It was noted that an earlier version of the draft Better Care Fund Plan had been sent to NHS England for their comments. In response NHS England commented that the draft Plan was fine, with the only areas they suggested needed sharpening up were a number of the timescales. It was confirmed that those changes would be made prior to the Final Plan being put before the Health and Wellbeing Board.

RESOLVED:

That Cabinet supported the draft plan and authorise the Health and Wellbeing Board to approve the final plan.

5. ADOPTION OF MERTON'S COMMUNITY INFRASTRUCTURE LEVY (CIL) INITIAL STRATEGIC INFRASTRUCTURE LIST (Agenda Item 5)

The Cabinet Member for Environmental Sustainability and Regeneration presented the report, which explained that the Council was statutorily required to publish a list of the strategic infrastructure that it would spend the Community Infrastructure Levy (CIL) funding on. The report set out the proposals for the initial Strategic Infrastructure List for adoption.

The Cabinet had regard to the tabled paper comprising a reference from the Borough Plan Advisory Committee (BPAC) and the recommendations and supporting narrative in the submitted report. On the BPAC recommendations the Cabinet felt that with regard to the proposal contained within 2.1.1, as funding had been budgeted for Morden Park Pool, thus there was no need to make specific reference, but felt that a general category of Leisure Centres should be included. Members were happy to support the principle of the proposal in 2.1.2. On the proposal contained within 2.1.3, Members choose to note it, as the Council was statutorily required to go out for public consultation on the List, it was therefore felt unnecessary.

RESOLVED:

1). That the Cabinet recommends to Full Council that it adopts Merton's Community Infrastructure Levy initial Strategic Infrastructure List (Reg 123 List) in order to continue to secure developer contributions once Merton's CIL is in place.

2). That a new category of Leisure Centres be added to the initial Strategic Infrastructure List

3). That, the following be added to the Education and School Provision category, *'and to support the building of a new school, should it be required.'*

6. ADOPTION OF MORDEN STATION PLANNING BRIEF (Agenda Item 6)

The Cabinet Member for Environmental Sustainability and Regeneration, introduced the report, which detailed the process that had been followed in the development of the proposed Morden Station Planning Brief, including the extensive consultation. It was noted that a copy of the proposed planning brief was included from page 157 within the report.

The Cabinet had regard to the tabled paper comprising a reference from the Borough Plan Advisory (BPAC) Committee and the recommendations and supporting narrative in the submitted report.

RESOLVED:

That Cabinet adopts the Morden Station Planning Brief as a supplementary planning document to Merton's Core Planning Strategy.

7. ALLOCATION OF S.106 MONIES TO CONNECTING COLLIERS WOOD (Agenda Item 7)

The Cabinet Member for Environmental Sustainability and Regeneration presented the report, which sought Section 106 contributions towards the public realm improvement scheme at Colliers Wood.

RESOLVED:

That the Cabinet agrees to the S106 contribution request, as detailed within the report, being allocated to the Connecting Colliers Wood project, in accordance with the S.106 Spend Parameters set out in paragraph 1.2.

8. ALLOCATION OF S.106 MONIES - MITCHAM COMMON CONSERVATORS (Agenda Item 8)

Councillor Whelton left the room for this item.

The Cabinet Member for Environmental Sustainability and Regeneration presented the report, which sought Section 106 contributions for the enhancement, maintenance and management of Mitcham Common by the Mitcham Common Conservators.

RESOLVED:

That Cabinet approves the allocation of £100,000 of S106 monies, associated with the development of the site of the former Windmill Trading Estate, 302-312 Commonside East, Mitcham, for the enhancement, maintenance and management of Mitcham Common by the Mitcham Common Conservators.

9. REFERENCE FROM SUSTAINABLE COMMUNITIES SCRUTINY PANEL - 20MPH ZONES/LIMITS (Agenda Item 9)

The Cabinet considered the Sustainable Communities Scrutiny Panel's reference on 20mph Zones and limits. The Cabinet Member for Environmental Sustainability and Regeneration addressed the recommendations saying that road safety was always an area of concern, but 20mph zones/limits were a clear area of debate both within the Borough and across the whole of London. The data on such zones was very limited and inconclusive, with minimal research demonstrating the real effects and impact. There was also little comparison on such speed restrictions against the impact of other calming measure such as speed humps or width restrictions. It was also emphasised that only the Police had the authority to enforce 20mph zones, which they were not currently doing.

The Cabinet was informed by the Director of Environment and Regeneration that recently, a cross London piece of work had been commissioned, to look at that particular issue. The empirical finding should be available reasonably soon and could help the Cabinet in making a more informed decision on its response to the Scrutiny recommendations.

RESOLVED:

That the Cabinet notes the Scrutiny's proposals and will respond to Sustainable Communities Overview and Scrutiny Panel in due course.

10. SECTION 75 PARTNERSHIP AGREEMENT FOR MENTAL HEALTH SERVICES (Agenda Item 10)

The Cabinet Member for Adult Social Care and Health presented the report, which requested the Cabinet to support and approve the renewal of the Section 75 agreement with SW London and St George's NHS Mental Health Trust, to pool community mental health, and relevant social care staff and budgets. The aim of the agreement was to maximise the effectiveness and efficiency of mental health provision, and to provide a seamless service for our adult customers with mental health needs. It was noted that the partnership arrangement had been in place since 2001.

RESOLVED:

1). That Cabinet agrees the Section 75 Agreement and all its attached schedules, subject to the approval of the Health and Wellbeing Board

2). That the Director of Community and Housing be authorised to join the Chief Executive of the Trust to oversee the operation of the agreement 1.

11. FINANCIAL MONITORING - JANUARY 2014 (Agenda Item 11)

Reason for urgency: The Chair has approved the submission of this report as a matter of urgency as it provides the latest available monitoring information for 2013/14. This requires consideration as it has implications for current and future years' budget monitoring and management

The Deputy Leader and Cabinet Member for Finance presented the report, which provided the regular financial monitoring update. It was noted that the monitoring report also contained a new section on performance management data, which would now be a regular part of the report.

RESOLVED:

That Cabinet

1). notes the financial reporting data relating to revenue budgetary control, showing a forecast underspend at year end of £1,014k (which is 0.19% of the Gross Council Budget) after allowing for a £496k transfer to the Capital Programme, £1,500k transfer to balancing the budget reserve, £1,717k carry forward of Public Health funds.

2). notes the adjustments and capital virements detailed in Appendix 5b and the Current Capital Programme as detailed in Appendix 5a.

3). notes the current progress to date on savings.

4). a) note the review of the departmental performance against service plan indicators as at 31 January 2014, and requests that the areas of under performance be addressed so targets are met by the end of March 2014.
b). notes those measures which are over performing by 20% or above, over target.
c). notes the changes of the Single Data List (SDL) 2013-14.
d). notes the frequency that performance data would be reported to Cabinet in future.

12. EXCLUSION OF THE PUBLIC (Agenda Item 12)

RESOLVED;

That the public are excluded from the meeting during consideration of the following item on the grounds that it is exempt from disclosure by virtue of Part 4B, Paragraph 10.4 and Category 3 of the constitution

13. PRINT MANAGED SERVICE CONTRACT (Agenda Item 13)

The Deputy Leader and Cabinet Member for Finance presented the report, which provided details of the tender process for the Council's contract for the supply and maintenance of new photocopiers/ printers and high volume print room equipment.

RESOLVED:

That Cabinet awards a contract for the supply and maintenance of new photocopier/printers and high volume print room equipment to the successful tenderer Altodigital Networks Ltd for an initial contract period of 3 years commencing 1 June 2014, with an option to extend for a further period of 3 years at the discretion of the Council. If the contract extension is executed the total contract price is £2,418,426.

14. PRIMARY SCHOOL EXPANSION CAPITAL PROJECTS (Agenda Item 14)

Reason for urgency: The Chair has approved the submission of this report as a matter of urgency as it requires permission to enter into a contract to meet the urgent need for primary school places. The report could not be finalised until after the Budget Council meeting on 6 March 2014 as it commits the Council to funding approved at that meeting.

Exemption - The Chair of the Overview & Scrutiny Commission, has confirmed in accordance with the provisions of Part 4B, Paragraph 10.4 and Category 3 of the Constitution, he was satisfied that the report qualifies for exemption as it contains information relating to the financial affairs of any particular person (including the authority holding that information), as set out in Category 3.

The Cabinet Member for Education presented the report, which sought formal agreement to commence construction for Pelham Primary School Expansion and an update on the processes and approvals required for the expansions of Merton Abbey, Singlegate and Dundonald Primary Schools.

RESOLVED:

That the Cabinet

1). agrees to enter into a construction contract to Mansell PLC for the expansion of Pelham Primary School to the maximum contract value of £5,055,909, requiring a virement of £702,000 from Primary School Expansion Contingency in 2015/16.

2). notes that following the pre-construction agreement with Mansell PLC and earlier approved phase works it will be necessary to enter into construction contracts with Mansell PLC for the expansions of Singlegate (adaptation phase) and Merton Abbey (final phase) by May 2014. In view of the contracts being over £2 million and there being no timetabled Cabinet meeting until 30 June 2014 a specific Cabinet meeting would need to called to avoid undue delay, with the necessary notice.

3). notes that the remaining major primary school expansion project to contract in 2014 will be Dundonald Primary School, which is being procured through competitive tender in two phases. In view of the contract value for both phases being over £2 million and there being no timetabled Cabinet meeting until 30 June 2014 a specific Cabinet meeting may need to be set up to avoid undue delay.

4). notes the current estimated costs for the schemes outlined in table 2 of the report,

5). Requests Council agree that the £1,134,483 of received Section 106 contributions for education should be formally allocated to contribute towards the capital cost for the expansion schemes at Dundonald, Merton Abbey and Pelham Primary Schools.

6). approves the virements as shown below:

	2013/14 £000s	2014/15 £000s	2015/16 £000s	2016/17 £000s	Total £000s
Dundonald	0	295	243	0	538
Merton Abbey	0	0	645	0	646
Pelham	0	0	702	0	702
Singlegate	0	274	975	0	1,249
Total	0	570	2,565	0	3,134
Contingency	0	(569)	(2,565)	0	(3,134)
Total	0	1	(1)	0	0

This page is intentionally left blank

Committee: Cabinet
Date: 23 April 2014
Agenda item:
Wards: All

Subject: Collaboration by London Councils for a Collective Investment Vehicle

Lead officer: Caroline Holland
Lead member: Councillor Mark Allison
Forward Plan reference number: ??
Contact office: Paul Dale

Recommendations:

That Cabinet:

a) agree to become a shareholder in a private company limited by shares which will be incorporated to be the Authorised Contractual Scheme Operator (the ACS Operator") of the Collective Investment Vehicle;

b) note that participation by London Boroughs is voluntary;

c) agree to contribute £1 to the ACS Operator as initial capital;

d) agree to join the London Boroughs "Pensions CIV Joint Committee", to be formed under section 102 of the Local Government Act 1972 and to delegate to such Joint Committee those functions necessary for the proper functioning of the ACS Operator, including the effective oversight of the ACS Operator and the appointment of Directors;

e) to nominate the Chair of the Pension Fund Advisory Committee authority to act as the Leader's deputy
for the Council in exercising its rights as a shareholder of the ACS Operator.

f) To note that should members agree to recommendations a) and c), there is a possibility that there could be a call from shareholding boroughs for a small initial investment as discussed in section 2.12 for capital required for the initial authorisation of the Operator The Director of Corporate Services will clarify this issue prior to signing any membership agreement and report further to the Cabinet meeting. The Director of Corporate Services would make any minor spending/investment decision required under delegated authority following consultation with the Cabinet Member for Finance and the chair of the Pension Fund Advisory Panel and would report any action to subsequent meetings of both Cabinet and Panel.

g Note that other investments will be considered by PFAC and a recommendation made to the appropriate decision making body.

.

1. SUMMARY

1.1 The Pension Fund Advisory Committee (PFAC) at its meeting of 19 March 2014 considered the proposal from London Council's Leaders Committee that London Boroughs collaboratively set a London-wide collective investment vehicle (CIV).

1.2 The future of management of the Local Government pension scheme has been the subject of much political and academic debate in recent years. The Local Government Pension Scheme (LGPS) is distinct from the other main public sector schemes in being funded. This means that contributions from employers and employees are placed in a fund that is then invested in assets such as stocks and shares, property and government bonds. These accumulated assets will be used to pay out pensions when they become due in the future. Getting a good return on the investments is crucial to the health of the pension fund and as any deficit for council employees in the scheme is picked up by the revenue budget it is also important to the council's general financial position,

1.3 Currently there are over 80 schemes in England and Wales, with 33 of these being administered by each London Borough and the City Corporation. Merton manages one of the smaller of the schemes with assets of c. £500m

1.4 There are those who have argued that there are economies of scale that can be gained by merging schemes into a smaller number of funds and potentially into one National Fund. The Government currently has a review underway on the future of the LGPS.

1.5 Conversely others have argued that the case for merger has not been made and that this could have several drawbacks

- The evidence that performance is directly linked to increase in size has not been fully made to the satisfaction of all
- Some have argued that asset selection and benchmarking have had the main impact on performance rather than a narrow focus on fee minimization.
- There could be a loss of local accountability with some of the schemes
- The scale of investment pots required could limit the number of investment managers able to provide the service hence reducing competition amongst providers

1.6 London Councils' Leaders committee has for some time been exploring an option, a Collective Investment Vehicle (CIV) that attempts to gain potential economies of scale without some of the perceived disbenefits. In this model existing pension funds would remain in place but they would voluntarily pool money to be invested collectively. The higher sums invested should produce lower investment fees but decisions on the patterns of investment would remain locally with boroughs.

1.7 This report requests members to take the next steps in enabling this CIV approach to be developed and for the Pension Fund to set the foundation to enable it use the vehicle should it require it in the future. PFAC took the view that the CIV was an option that they would like to have available to them as they are currently reviewing the investment mandate of the fund. At this stage, however, they are not seeking to commit to any particular level (or indeed any) investment.

2 DETAIL

London Councils Leaders' Committee has considered the issue of collectiveinvestments for London Pension Funds throughout 2012 and 2013. They have concluded that more collaboration between boroughs that wished to collectively invest some or all of their pension funds would be likely to produce significant savings. The London Councils Leaders' Committee has approved the detailed business case and a proposed governance structure. They have also approved that a London Local Government Pension Scheme (LGPS) Collective Investment Vehicle (CIV), in the form of a UK based, Financial Conduct Authority (FCA) approved, authorised Contractual Scheme (ACS) be set up. This report details the action that the Council needs to take to enable participation.

2.2 At their meeting on 11 February 2014, London Councils Leaders' Committee approved that they should recommend to the London boroughs that they proceed to establish an Authorised Contractual Scheme (ACS) and an ACS Operator (which is the company that would manage the ACS). This would require London boroughs to agree to become shareholders in the ACS Operator and delegate oversight of the company to a Joint Committee hosted by London Councils. A copy of the paper submitted to London Councils Leaders Committee is appended (Appendix A).The Report sets out the likely Governance structures and key principles. The principles include:

- investment in the ACS should be voluntary;
- ability to choose how much to invest in individual asset classes;
- boroughs should have sufficient control over the ACS Operator;
- the ACS Operator would provide regular information to participating boroughs; and
- Authorities seeking to invest in the ACS will also take a shareholding interest in the Operator (and have membership of the Pensions CIV Joint Committee).

2.3 The Joint Committee would be established under the existing London Councils arrangements to assist in the appointment of directors to the ACS Operator. The Pensions CIV Joint Committee will comprise elected Councilors nominated by participating boroughs as provided for under the existing London Councils Governing Agreement.

2.4 Information will be provided regularly by the ACS and the ACS Operator to local authorities investing, and their Pension Committees and officers, and the Pensions CIV Joint Committee. Directors of Finance will provide advice to both the borough Pension Committees (as they do now) and to their authority's representative on the Pensions CIV Joint Committee. The London Council's report proposes that the Chairman of the Pensions Committee represents the Council or in the event that all 33 boroughs decide to join then the Leader fulfills this role, as in that event the existing London Councils Leaders Committee can undertake the role.

2.5 The business case considered by London Councils analysed the savings, benefits and costs for a variety of different levels of collective assets under management: £24bn, £10bn and £5bn, producing estimated annual net savings of £112.2million, £44.9 million and £20.9million respectively. It is considered that a reasonable minimum target size of assets under management for the ACS is in the range of £5bn. This is based on analysis of existing investments held by London borough funds and also takes into account that initially the majority of investment mandates are likely to be passive mandates. Over time, it is expected that actively managed mandates and investments into alternatives such as property and infrastructure assets may be added to the range of investments offered by the ACS.

2.6 All London boroughs have been asked to respond to respond in writing to the London Councils Chief Executive on their decision on two issues: whether to join the CIV Company and also to participate in a new Joint Committee that is being set up to govern the structure.

2.7 At this stage no commitments to any future investments are being sought. The proposal at this stage is purely to establish a mechanism that would allow collective investments to be made. Decisions to make any investment would only be made by members following consideration by PFAC on the recommendation of its Investment adviser and consideration that such investments is in line with the strategic asset allocation of the pension fund. PFAC would also be considering whether there are transition fee implications to move investments from existing investment managers to the CIV. Other issues like the fees to be charged by the operator would be considered.

2.8 It should be noted that, participation is voluntary by boroughs, and even if a borough decides to participate each borough will make separate decisions to invest, disinvest or not invest at all for each asset mandate in the same way that Pensions Committees do currently. It is expected that the decision as to whether to invest in the ACS would be made by individual boroughs later in the year. There is nothing in the decision or report that locks any borough into any level of commitment to invest or at what stage in the process not to proceed.

2.9. To date the initial one off costs of working up the CIV have been met by an initial contribution of £25,000 each from 25 of London's 33 boroughs.

2.10 In broad terms, the proposed structure is that the boroughs will own all the share capital of the ACS Operator. Initially this will require minimal share capital (£1 per borough) but this capital requirement will increase once the operator is authorised and investments are made in the ACS. It is anticipated that, some or all of, the capital contributions will be converted into bond investments that form part of the investments of investing boroughs.

2.11 Following the report to the London Councils Leaders Committee further information has been provided by London Councils (attached as Appendix 2) This identifies that at there are 2 points at which the Operator of the Authorised Contractual SchemeI will require further capital: the initial authorisation of the Operator and then the date on which the Operator goes live in terms of managing the ACS fund.

2.12 The Operator is likely to be authorised in mid to late 2014 and accordingly at this point, regulatory capital of €125,000 will be required. At this stage it is not clear if the shareholders would be required to contribute this or if it will be restricted to those making actual investments. London Councils have now indicated that shareholding boroughs could be asked to share the initial €125k. The London Councils' estimate is that there are likely to be at least 20 boroughs leading to an investment of c. €6,250 apiece. It should be noted that this is not an expense but would be an investment that would be made in bonds or cash. The participating boroughs would retain the value of the investment but there may be a small loss of income from them.

2.13 London Councils' have expressed the view further capital requirements will be required, as investments start to flow, and would be linked to the scale of investment being made. The paper (Appendix 2) notes that there is a capital ceiling of €10m, which, on the basis of 20 boroughs, would equate to a total capital requirement of €500k per borough. Both of the capital calls are based on the requirements of the regulatory regime.

2.14 As the paper notes, all of this capital would be invested in liquid assets and would be returned to a borough if they decided to withdraw from the CIV, although again the precise details of how this would operate are still to be worked through.

2.11 In the longer term, running costs incurred in operating the CIV would be recoverable from participating boroughs who actually invested in the funds operated by the CIV. The intention is that these would be more than paid for from reduced fees. The objective of the CIV is to harness the joint purchasing power of the participating boroughs to drive down fund managers' fees and improve investment performance. The CIV could potentially provide an expedient way of enhancing investment objectives of the London Borough of Merton Pension Fund without undermining Member control and autonomy.

3. FINANCIAL, RESOURCE AND PROPERTY IMPLICATIONS

Financial Implications have been included in this report. The council has contributed £25k under delegated authority from the Pension fund towards the exploratory work on setting up the CIV.

4. LEGAL AND STATUTORY IMPLICATIONS

4.1 London Councils commissioned external legal advisers, Eversheds LLP, to advise on the statutory powers to enter into this arrangement and to advise on matters regarding governance. The advice is available as a background paper.

4.2 Eversheds advised that the matters requiring decision in this report are matters for the executive. Therefore, the decision to establish a joint committee is also an executive decision.

4.3 Under the provisions of the London Councils Governing Agreement the Leader is the Council's representative on the joint committee but the Leader is able to appoint a deputy. Under Regulation 12(3)(a) of the Local Authorities (Arrangements for the Discharge of Functions) (England) Regulations 2012, non-executive members can be appointed to an executive joint committee if there are more than 5 participating authorities.

5. HUMAN RIGHTS, EQUALITIES AND COMMUNITY COHESION KLE

IMPLICATIONS

This report has no direct human rights, equalities and community cohesion implications

6. RISK MANAGEMENT AND HEALTH AND SAFETY IMPLICATIONS

N/A

7. APPENDICES

1. London Council's Leaders Reports presented at London Council meetings between March 2012 to December 2013

2 Further London Council's Guidance on Timing and quantum of regulatory capital requirements for London Councils' Operator of the Authorised Contractual Scheme

8. BACKGROUND PAPERS

High level detail on the governance arrangements and FCA regulation of the ACS Operator and the Pensions CIV Joint Committee – Eversheds 13 February 2014

Leaders' Committee

Pensions Working Group: Progress report, business case, and proposed next steps towards a London LGPS CIV

Item no: X

Report by: Hugh Grover **Job title:** Director, Fair Funding, Performance and Procurement

Date: 11 February 2014

Contact Officer:

~~**Telephone:** 020 7934 9942 **Email:** hugh.grover@londoncouncils.gov.uk~~

Summary

This report follows on from previous discussions, in particular at Leaders' Committee throughout 2012, and in May and December of 2013, and discussions at the Executive in September and November 2013. Those discussions have focused on the potential for more collaboration between boroughs that wished to do so, on the management and investment of pension funds.

In response to the report presented to Leaders' Committee in December 2013, London Councils has engaged expert legal and financial services advisors to develop a robust business case and formal proposal to inform decisions for implementation of a London LGPS Collective Investment Vehicle (CIV), in the form of a UK based, Financial Conduct Authority (FCA) Authorised Contractual Scheme (ACS).

This report which reflects the views and advice of the advisers, in consultation with London Councils' legal advisors from the City of London Corporation, fulfils that request. It sets out the current thinking of the Pensions Working Group (PWG) and asks Leaders' Committee to recommend to the boroughs that they proceed to establish an Authorised Contractual Scheme (ACS) and the ACS Operator (which is the company that would manage the ACS)

It should be noted that, all the proposals outlined in this report are based on voluntary participation by boroughs, and the decision as to whether to invest in the ACS would be made by individual boroughs later in the year. There is nothing proposed in the report that locks any borough into any level of commitment to invest.

Dialogue with HM Government relating to the Government's review of Local Government Pension Schemes is ongoing, and it is apprised of the progress made to date by London Councils and the PWG. At the time of writing the report, we still await the Government announcement on their proposed direction of travel.

This report provides an overview of the proposals and recommendations, Annex A provides Elected members with the underlying detail.

Recommendations Leaders' Committee is asked to:

1. Consider the report and the underlying business case supporting the establishment of a collective investment vehicle, in the form of an authorised contractual scheme (the "ACS"), for local authority pensions in London ("the Arrangements"); AND
2. Endorse and recommend to each local authority which decides to participate that, they resolve that:
   (a) a private company limited by shares be incorporated to be the Authorised Contractual Scheme Operator (the "ACS Operator"), structured and governed as outlined in this report, and that the local authority agrees –
      (i) to become a shareholder in the ACS Operator, and
      (ii) to contribute £1 to the ACS Operator as initial capital, and
      (iii) to appoint an elected Councillor who will have power to act for the local authority in exercising its rights as a shareholder of the ACS Operator, and
      (iv) that Mayor Pipe, Councillors O'Neill and Dombey, Mr Chris Bilsland (Chamberlain, City of London), Mr Chris Buss (Finance Director, LB Wandsworth), Mr Ian Williams (Finance Director, LB Hackney), and Mr John O'Brien (Chief Executive, London Councils) be appointed as the interim Directors of the ACS Operator, subject to the consent of their relevant authorities to the appointments. These directors may be replaced once FCA authorisation is formally applied for; and
   (b) a representative body, in the form of a new sectoral joint committee (the "Pensions CIV Joint Committee"), is established (pursuant to the existing London Councils Governing Agreement, dated 13 December 2001 (as amended)) to act as a representative body for those local authorities that resolve, in accordance with 2(a) above, to participate in the Arrangement (or in the alternative, should all 33 London authorities resolve to participate, that Leaders' Committee exercise these functions and the Governing Agreement be varied accordingly); and
   (c) All London local authorities respond in writing to the London Councils Chief Executive, by 14 April 2014, or before the day of the local government elections (22 May 2014), to advise of their decisions regarding the matters set out at paragraphs 2(a) and 2(b) above.

Pensions Working Group: Progress report and proposed next steps towards a London LGPS CIV

Introduction

1. At its December 2013 meeting, Leaders' Committee received a progress update from the Pensions Working Group (PWG), which outlined the views and recommendations of the PWG in respect of the potential London LGPS Collective Investment Vehicle (CIV). Leaders' Committee agreed the recommendations of the PWG that a business case and formal proposal should be prepared to inform decisions for implementation of a CIV which should be structured as a UK based, Financial Conduct Authority (FCA) Authorised Contractual Scheme (ACS). This report sets out the proposed business case, and formal proposal as to how to proceed. Leaders' Committee is asked to endorse the formal proposal for the formation of the ACS and its Operator, and to recommend the proposal to their own Council.

2. This paper recaps the financial benefits which may arise from operating an ACS, and sets out further details of the expected costs. It also sets out further details of the proposed structure of the ACS and potential governance arrangements (including the ACS Operator), together with the steps that are required to progress the project and establish the ACS and its Operator. This is set out in detail in Annex A, which should be read in conjunction with this report. The decision as to whether to invest in the ACS, once established, will remain with each Borough Pensions Committee and is distinct from the decision which is now being recommended to establish a new Pensions CIV Joint Committee and the Operator of the ACS. Any decisions regarding investment in the ACS will not begin until later in the year and are likely to be on an asset class by asset class basis.

Background

3. In 2012, a report from PwC set out options for reconfiguring the London LGPS funds, and indicated the possible financial benefits of a CIV. Since then, the matter has been discussed several times, and it was agreed that further consideration should be given to creating a CIV, and that the most appropriate structure for the CIV would be an ACS. A number of the local authorities agreed to contribute £25-£50k towards exploring the proposal which are held in a designated fund by London Councils. These contributions will fund the professional costs associated with development of the proposed ACS and its Operator.

4. The Government issued a call for evidence on the future structure of the LGPS last year, and sought professional advice to consider either Collective Investment Vehicles or merger of funds as potential routes forward. This advice, being provided by Hymans Robertson, and the Government consultation are expected to be published shortly. However, it is unlikely that this will be ahead of Leaders' Committee meeting. Nonetheless, informal indications are that, while undoubtedly Leaders' Committee position will need to be considered in the light of whatever is published, it seems unlikely that the benefit of CIVs will be fundamentally challenged.

5. At its December 2013 meeting, Leaders' Committee resolved to engage expert legal and financial services advisors to assist in the development of the ACS and its Operator. These advisors, along with a Custodian advisor, have been appointed and over recent weeks further analysis has been undertaken on the legal, regulatory, and financial aspects of implementing the CIV, in consultation with City of London lawyers who are London Councils' general legal advisors. The Leaders' Committee asked the PWG, having regard to that specialist advice, to develop a robust business case and formal proposal to proceed with implementation of the ACS to inform Boroughs' decisions, and this is set out in the sections which follow.

Proposed structure

6. It was previously agreed that the most appropriate structure for the CIV is an ACS fund and nothing has emerged to suggest that that recommendation should change. The ACS will require an FCA regulated ACS Operator to be established. The board of directors and employees of this company will have overall responsibility for the operation of the ACS.

7. In considering the proposed structure of the ACS and its Operator, the PWG has sought to adhere to the following overarching principles, in order that the arrangement can best meet the requirements of the boroughs:

   a) Investment in the ACS should be voluntary. A borough should be able to decide it does not wish to participate, or to the extent it initially decided to participate, to choose to withdraw its investment.

   b) If a borough chose to invest, it will be able to choose which asset classes to invest into, and how much it might invest into each asset class.

   c) The boroughs should have sufficient control over the ACS Operator, in order to be assured that it will be acting in their best interests.

   d) The ACS Operator would provide regular information to participating boroughs regarding the performance of managers, investment options, and other areas, so that information continues to be available to the same extent it is currently in order for boroughs to make investment decisions.

   e) Authorities seeking to invest in the ACS will also take a shareholding interest in the Operator (and have membership of the Pensions CIV Joint Committee).

   f) The ACS will not increase the overall investment risk faced by boroughs.

8. The ownership structure and process for governance and decision making of the ACS Operator has been considered in some detail and is set out in the diagram below. The analysis contained in this paper including the Annex is a summary of the key issues associated with the establishment of the structure. Additional detail including in particular legal and regulatory analysis will be required in due course as the project progresses.

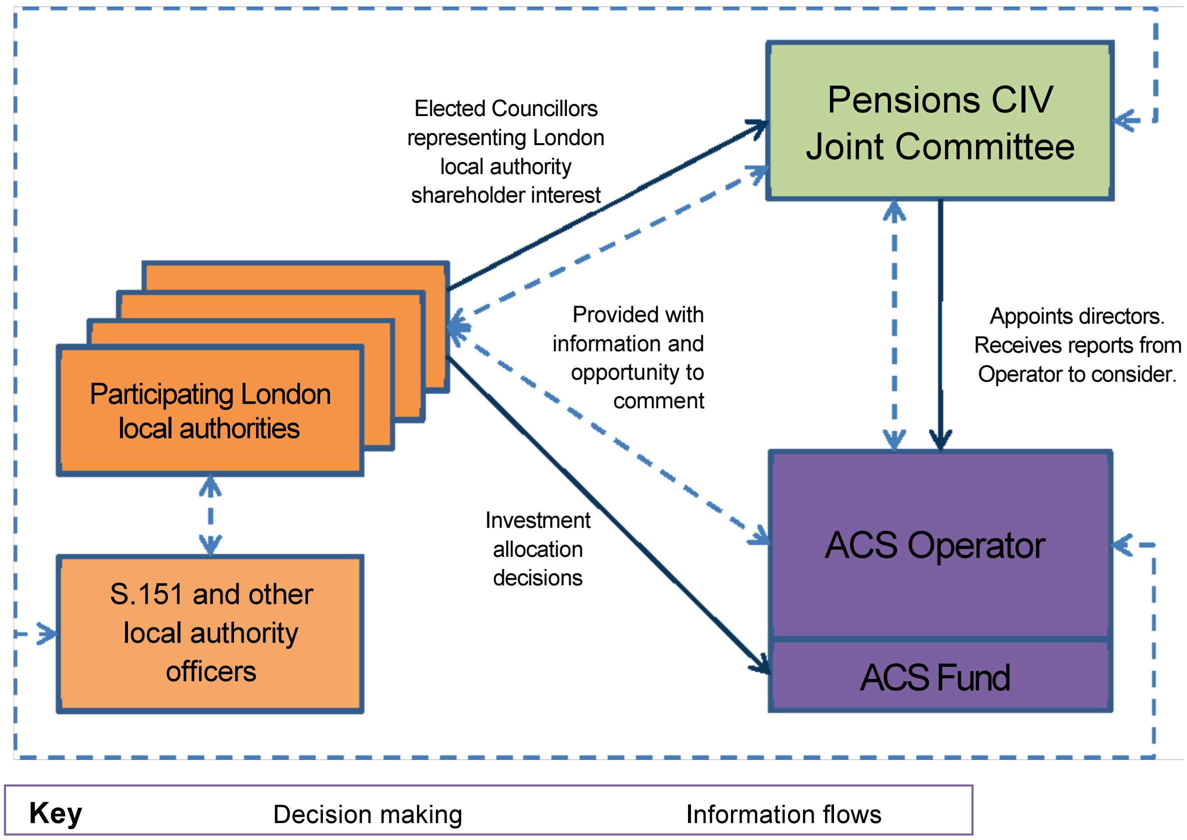
9. In broad terms, the proposed structure is that the boroughs will own all the share capital of the ACS Operator. Initially this will require minimal share capital (£1 per borough) but this capital requirement will increase once the operator is authorised and investments

are made in the ACS. The capital requirements are considered in more detail below (see paragraphs 14-18).

10. A new 'Pensions CIV Joint Committee' will be established under the existing London Councils arrangements to assist in the appointment of directors to the ACS Operator. The Pensions CIV Joint Committee will comprise elected Councillors nominated by participating boroughs as provided for under the existing London Councils Governing Agreement. Information will be provided regularly by the ACS and the ACS Operator to local authorities investing, and their Pension Committees and officers, and the Pensions CIV Joint Committee. Borough treasurers will provide advice to both the borough Pension Committees (as they do now) and to their authority's representative on the Pensions CIV Joint Committee.

11. The governance arrangements and lines of communication between various interested parties are illustrated in the diagram below.

Fig 1 – CIV governance and communication lines



12. The proposed structure has been designed to allow boroughs to have strong oversight and control over the ACS Operator. This oversight and control is achieved at a number of levels including the following:

a) The boroughs will own all the shares in the ACS Operator and will be able to exert influence over the ACS Operator's board and activities through their shareholdings;

b) The 'Pensions CIV Joint Committee' will be made up of elected Councillors nominated by their boroughs. This Joint Committee will represent and assist the boroughs having a shareholding in the ACS and will have the power to identify and appoint key directors to the ACS Operator. It would also be a forum to discuss key issues which affect the participating local authorities, both individually and collectively;

c) Subject to regulatory requirements, the board of directors of the ACS Operator is likely to include some representatives of the shareholders of the ACS Operator (expected to be appointed from the elected Councillors who will sit on the Pensions CIV Joint Committee and who will represent all participating local authorities' interests);

d) The ACS operator will require staff (on a part-time basis) to assist in activities including investment manager selection and it is proposed that as many of these roles as possible may be undertaken by existing elected Councillors and officers of boroughs with relevant experience; and

e) Information relating to the performance of investments and the ACS Operator will be made available on a regular basis to boroughs investing and the Pensions CIV Joint Committee representing the boroughs' shareholding interest in the Operator.

13. Should boroughs be minded to proceed with establishing the ACS Operator, at this stage the company can be established with interim directors, with formal appointments for the ongoing directors made in the autumn, prior to FCA approval.

Capital requirements of the ACS Operator

14. Initially the ACS Operator will only require minimal share capital and, as such, it is recommended that each borough that wishes to proceed will acquire £1 of share capital in the company.

15. Immediately before the ACS Operator receives regulatory approval (expected to be 4th quarter 2014 or 1st quarter 2015), it will require capital of c£100,000. It is proposed that this capital would be contributed by those boroughs who choose to move forward with the ACS in Autumn – so for example if 10 boroughs decided to proceed with the ACS in Autumn, this would require a capital contribution of £10,000 per borough.

16. Once the ACS starts receiving investments, it will require additional capital. It is proposed that boroughs who invest pension assets in the ACS, would contribute capital to the ACS Operator in proportion to the assets invested, expected to be c.2 to 3 basis points of assets invested (e.g. for £5bn of assets invested in the ACS, the ACS Operator would require capital of £1m to £1.5m). It should be noted that this contribution is an investment rather than an expense as this capital would be invested in liquid assets such as gilts rather than being used to pay expenses.

17. It should be noted that this contribution is an investment rather than an expense as this capital would be invested in liquid assets such as guilts rather than being used to pay expenses. It is not expected that this should materially impact any return to the boroughs as the funds invested could be from existing pension assets which are currently invested in gilts or similar investments. As such the borough fund could retain

exactly the same investment profile except that a very small proportion of its assets invested via gilts would be held indirectly through the ACS Operator rather than directly as at present.

18. It should be noted that boroughs who contribute £1 of share capital now will be under no obligation to make any further capital payments to the ACS operator. To the extent a borough takes a subsequent decision to invest in the ACS, it is proposed the borough would at that point invest further capital. (see paragraph 15).

Financial case

19. Previous work undertaken by PwC estimated savings in the region of £120m per annum from the creation of a CIV (the ACS), provided there was close to full participation by the 33 London local authorities. These benefits arose from reduced investment management fees, and improved performance. Costs of running the ACS were estimated to be £4.8m if there was full participation from all the authorities. At lower levels of participation, both the financial benefits and the costs would reduce.

20. More work has now been undertaken on potential costs and benefits, based on high level assumptions, and these are summarised in the table below. Additional details on the savings and costs are set out at Annex A. It is clear that, based on the expected savings previously identified, forecast costs should be comfortably covered by savings in reduced management fees.

Fig 2 - Summary of savings and costs

	Assets under management £24bn £ **000's**	**Assets under management £10bn** **£000's**	**Assets under management £5bn** £ **000's**
Expected savings per annum	120,000	50,000	25,000
On-going Costs per annum	(6,100)	(3,650)	(2,750)
Establishment Costs	(1,700)	(1,500)	(1,400)

21. Savings and costs have been analysed for assets under management of £24bn, £10bn and £5bn. It is considered that a reasonable minimum target size of assets under management for the ACS is in the range of £5bn. This is based on analysis of existing investments held by LGPF funds undertaken by the PWG and also takes into account that initially the majority of investment mandates are likely to be passive mandates. Over time, it is expected that active mandates and investments into alternatives such as property and some infrastructure assets may be added to the range of investments offered by the ACS.

22. Even at a level of assets under management of £5bn, the expected savings materially outweigh the expected costs. The actual savings and costs will naturally depend on the number of participating boroughs, amount of assets under management and the mix of investments that are selected for the ACS. It is expected that additional work to decide

on new investment managers and to agree costs will begin in the 4th quarter 2014 in order that boroughs can make investment decisions in 1st quarter 2015.

23. There will be professional fees and other costs associated with making the ACS fully operational (described as Establishment Costs in Fig 2 above). £625,000 of these costs has already been funded by boroughs and £344,000 committed to date. It is currently proposed that any additional costs of establishment, over and above the £625,000, would be borne by boroughs that choose to participate further in Autumn.

24. It should be noted that there is no obligation for any boroughs that choose to agree the recommendations set out in this paper to commit to any additional funding of costs. To the extent a borough takes a subsequent decision to invest in the ACS, it is proposed the borough would at that point invest further capital. (see paragraph 15).

Next Steps

25. Broadly, if the recommendations of this paper are agreed, and a number of boroughs wish to participate in the joint arrangements, the following steps will be undertaken:

   a) A new joint committee, (the 'Pensions CIV Joint Committee') will be established under the relevant legislation and existing London Councils Governing arrangements. To the extent all 33 boroughs wish to participate, London Councils Leaders' Committee would fulfil this role instead and the London Councils' Governing Agreement varied accordingly.

   b) The ACS Operator will be established, with participating boroughs having £1 of share capital in the company, and interim directors appointed.

   c) Further work will be undertaken regarding the final design and operation of the ACS Operator and ACS. The documents required by the FCA for the ACS and the ACS Operator to become authorised will be prepared.

26. A proposal will be prepared for Leaders' Committee to consider in the Autumn which will provide a clear timetable and costs for obtaining regulatory approval for the ACS Operator and the ACS, request a commitment for the initial capital of c. £100,000 from those authorities wishing to participate such that the ACS Operator can be authorised and request funding for establishing the initial staffing of the ACS Operator, and to meet any further establishment costs (per paragraphs 23 and 24 above).

Recommendations

27. Leaders' Committee is asked to:

   1. Consider the report and the underlying business case supporting the establishment of a collective investment vehicle, in the form of an authorised contractual scheme (the "ACS"), for local authority pensions in London ("the Arrangements"); AND

   2. Endorse and recommend to each local authority which decides to participate that, they resolve that:

      (a) a private company limited by shares be incorporated to be the Authorised Contractual Scheme Operator (the "ACS Operator"), structured and governed as outlined in this report, and that the local authority agrees –

(i) to become a shareholder in the ACS Operator, and

(ii) to contribute £1 to the ACS Operator as initial capital, and

(iii) to appoint an elected Councillor who will have power to act for the local authority in exercising its rights as a shareholder of the ACS Operator, and

(iv) that Mayor Pipe, Councillors O'Neill and Dombey, Mr Chris Bilsland (Chamberlain, City of London), Mr Chris Buss (Finance Director, LB Wandsworth), Mr Ian Williams (Finance Director, LB Hackney), and Mr John O'Brien (Chief Executive, London Councils) be appointed as the interim Directors of the ACS Operator, subject to the consent of their relevant authorities to the appointments. These directors may be replaced once FCA authorisation is formally applied for; and

(b) a representative body, in the form of a new sectoral joint committee (the "Pensions CIV Joint Committee"), is established (pursuant to the existing London Councils Governing Agreement, dated 13 December 2001 (as amended)) to act as a representative body for those local authorities that resolve, in accordance with 2(a) above, to participate in the Arrangement (or in the alternative, should all 33 London authorities resolve to participate, that Leaders' Committee exercise these functions and the Governing Agreement be varied accordingly); and

(c) All London local authorities respond in writing to the London Councils Chief Executive, by 14 April 2014, or before the day of the local government elections (22 May 2014), to advise of their decisions regarding the matters set out at paragraphs 2(a) and 2(b) above.

Legal Implications

28. The main legal implications are contained in this report and the attached Annex. The detail of the structure and governance of the ACS and its Operator will be firmed up as the preparatory work progresses. The establishment of a joint committee will be in accordance with arrangements under the Local Government Act 1972 and the Local Government Act 2000 to arrange for the joint discharge of decision making by the participating local authorities to support the arrangements for the collective investment vehicle. The Joint Committee will initially be established under the London Councils Governing Agreement, and the Terms of Reference of the new joint committee will provide for shared administrative functions, a forum to discuss key issues and power to appoint key directors of the ACS Operator; and it could be used more broadly if boroughs felt that to be appropriate. Should all 33 London local authorities resolve to participate, Leaders' Committee would discharge the relevant local authority functions and the Governing Agreement formally varied accordingly.

29. The Councils have power to enter into these arrangements as part of their function as an administering pensions authority taking account of its duty to invest in the interests of the pension fund and obligations in the Local Government (Pension Scheme) Management and Investment of Funds Regulations 2009. Additionally Councils have

power to invest further to Section 12 of the Local Government Act 2003 and must act in accordance with principles of best value and their general fiduciary duty.

Financial Implications

30. The Director of Corporate Resources reports that the estimate of possible costs and benefits arising from the establishment of a collective investment vehicle are detailed in full within the Annex of this report and summarised in the table at paragraph 20.

31. These figures are initial estimates and will be firmed up as preparatory work progresses, particularly in relation to the establishment and on-going costs. As detailed in paragraph 23, 25 boroughs have each been invoiced for a sum of £25,000 as a contribution towards establishment costs, amounting to £625,000 in total, with £344,000 of that sum committed to date.

32. There are some governance related issues that require further clarification, particularly surrounding the accounting requirements of the newly proposed Pensions CIV Joint Committee and how this will relate to the existing London Councils financial structures and work will continue to clarify this position.

Equalities Implications

33. There are no equalities implications for London Councils.

Attachments

Annex A: Business Case

Background Papers

13 March 2012, Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=4796

13 November 2012, Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5072

11 December 2012, Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5109

14 May 2013, Leaders' Committee report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5252

19 September 2013, Executive report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5353

26 November 2013, Executive report:
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5490

10 December 2013, Leaders' Committee report
http://www.londoncouncils.gov.uk/committees/agenda.htm?pk_agenda_items=5495

Annex A

Business Case

1. At its December 2013 meeting, Leaders' Committee agreed the recommendations of the PWG that a business case and formal proposal should be prepared to proceed with implementation of a Collective Investment Vehicle, in the form of an Authorised Contractual Scheme (ACS). This Annex sets out the proposed business case.

2. This paper sets out further details of the proposed structure of the ACS and potential governance arrangements, including the establishment and capital requirements of the ACS Operator. It then recaps the financial benefits which may arise from operating an ACS, and sets out further details of the expected costs.

Proposed structure

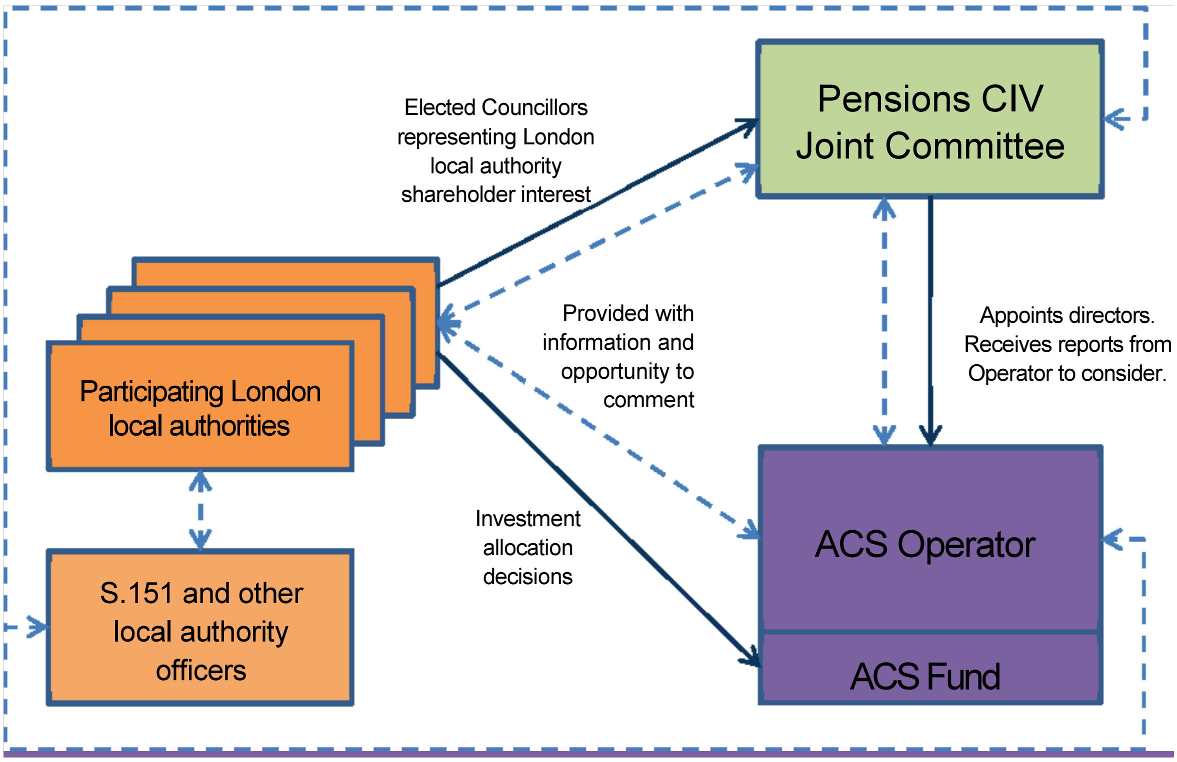
3. It was previously agreed that the most appropriate structure for the CIV is an ACS fund and nothing has emerged to suggest that that recommendation should change. The ACS will require an FCA regulated ACS Operator to be established. The board of directors and employees of this company will have overall responsibility for the operation of the ACS.

4. In broad terms, the proposed structure is that the participating boroughs will own all the share capital of the ACS Operator. Initially this will require minimal share capital (£1 per borough from those who wish to participate) but this capital requirement will increase once the operator is authorised and investments are made in the ACS. The capital requirements are considered in more detail at paragraph 32 onwards.

5. A new 'Pensions CIV Joint Committee' will be established to assist in the appointment of key directors of the ACS Operator, such as the Chairman and Chief Executive Officer. The Pensions CIV Joint Committee will comprise elected Councillors nominated by participating boroughs. Information will be provided regularly by the ACS Operator to investors in the ACS and borough Pension Committees and officers, and the Pensions CIV Joint Committee.

6. The governance arrangements and lines of communication between various interested parties are illustrated in the diagram below.

Fig 1 – CIV governance and communication lines



Key Decision making Information flows

7. The following sections set out the above arrangements in more detail, setting out the governance arrangements, potential staff requirements, and the proposed process for investment manager selection and asset allocation.

Governance structure of the ACS Operator

8. The process for governance and decision making has been considered in some detail, and there are a range of options for how the governance arrangements could be structured. The precise arrangements would always be open to Council scrutiny and amendment, and subject to FCA requirements, but what is laid out below is seen as appropriate initial proposals to take the project forward at this point. Extensive legal advice has been taken and has been used to formulate the proposals that lead to the framework described below.

9. It is proposed that a new joint committee (the ‘Pensions CIV Joint Committee’) will be established under both section 102 of the Local Government Act 1972, Section 9EB of the Local Government Act 2000, and clause 3.1 of the existing London Councils’ Governing Agreement, to act as a representative body for those local authorities that have chosen to participate, and would be made up of the Leaders (or another nominated elected Councillor) of those councils participating in the ACS. Should all the boroughs participate, this role would be performed by London Councils’ Leaders’ Committee (and the Governing Agreement would need to be formally varied). In relation to the make-up of this joint committee, it is proposed that boroughs that agree to become a shareholder in the ACS Operator would appoint a representative who will sit

on this committee. Whilst typically the borough Leader might be appointed as the representative on the joint committee, in the event that meetings are required to deal with specialist matters e.g. discussions on investment matters, it may be that a person with appropriate expertise would act as a deputy to attend such meetings, e.g. for investor matters, the Chair of the relevant Borough Pension Committee could be appointed. A deputy would need to be appointed at the same time as the main representative. Provision is made for these arrangements under the existing London Councils Governing Agreement dated 13 December 2001 (in particular refer to clauses 3.1 and 4.5 of the Agreement and Standing Orders).

10. One of the main purposes of the Pensions CIV Joint Committee will be to act as a forum to recommend/approve the appointment of key directors to the board of the ACS Operator. The ability to appoint directors of the ACS Operator ultimately rests with the shareholders (who in practice, the Elected Councillors sitting on the joint committee represent) and analysis is currently on-going to determine the most appropriate methodology for the wishes of the shareholders to be executed in a manner which is acceptable given various constraints that exist within local government, Companies Act 2006 requirements, and FCA regulations.

11. The exact mandate of the joint committee will require further consideration. The frequency of meetings of the joint committee also needs to be decided.

12. Should boroughs be minded to proceed with establishing the ACS Operator, at this stage the company can be established with interim directors, with formal appointments for the ongoing directors made later in the year, prior to FCA approval. It is proposed that, subject to no impediment for the individuals, the members of the Pensions Working Group would sensibly be asked to take the roles of interim directors, augmented by the Chief Executive of London Councils. For clarity that would be Mayor Pipe, Councillors O'Neill and Dombey, Mr Chris Bilsland (Chamberlain, City of London), Mr Chris Buss (Finance Director, LB Wandsworth), Mr Ian Williams (Finance Director, LB Hackney), and Mr John O'Brien (Chief Executive, London Councils). Their appointment would be subject to the consent of their relevant authorities.

13. It is proposed that up to three elected Councillors from the Pensions CIV Joint Committee could be directors of the ACS Operator. The directors have to be approved by the FCA and will have fiduciary duties and responsibilities. The decision as to who could be in these roles is to be decided. It is not a requirement for Elected Councillors sitting on the joint committee to have any director roles, and this will be one of the early matters on which the initial participating boroughs who join the joint committee and participate in the ACS will be asked to decide.

14. The ACS Operator will provide regular information to the participating Borough Pensions Committees about the ACS. The Borough Pensions Committees would be given the right to receive presentations by the investment managers on performance.

15. As illustrated in Figure 1, it is recognised that s.151 officers will provide advice to both their representative joint committee elected Councillor, and their Borough Pension Committee. In addition, it is anticipated that Treasurers may require occasional opportunities to receive information directly from the ACS Operator and to raise any

issues or questions. The Society of London Treasurers is likely to have a role in facilitating discussions with the ACS Operator at an officer level where those matters under discussion collectively affect Treasurers‘ authorities.

Staff resources

16. In terms of staffing requirements, there are a number of roles required within the ACS Operator, and the precise detail of the final establishment of the ACS Operator will need to be confirmed later. However, in order to understand costs, the following has been assumed. Firstly, there would be 2-3 FTE admin staff, who are likely to be graded at bands B and C on London Councils' salary scales. These staff would assist in the running of the ACS Operator, for example drafting and reviewing reports, and providing support to the meetings of the board of directors, relevant committees of the board, and support teams.

17. At the outset, there will also be a lot of activity in respect of investment management selection. This may require 5 to 6 individuals, with a strong level of understanding of the process for selection of managers. It is thought that this group could comprise of a number of existing borough pensions staff, potentially seconded into the ACS Operator for a period of time. Potentially an external hire may also be required. This group would undertake the activities which would ultimately lead to a recommendation being made to the ACS board as to investment mandates of the ACS and the managers to appoint, in a similar fashion to the existing arrangements within boroughs where pension officers will report to their Pensions Committee. Further details are set out at paragraph 22 onwards.

18. To oversee the activities set out above, and oversee and manage suppliers, it is expected that a chief operating officer would be required. In the first instance, this is likely to be a full time role, however once the ACS Operator and ACS are fully established, the time required may decrease. The need for this role, its responsibilities, and options for filling it, could be considered by the ACS Operator interim directors (see paragraph 12).

19. In addition, a chief executive officer and finance director would be required. These are expected to be part time roles, and could potentially be undertaken within the existing roles of London Councils. These decisions do not need to be taken immediately and, again, could be addressed by the interim directors as one of their early decisions. A compliance director, risk officer, anti-money laundering officer, and chief investment officer will also be required, and how to source these individuals will be considered as an early part of the process. It should be noted that, in addition to the liability of the corporate entity, individuals in these roles need approval from the FCA and have personal liability.

20. To the extent that resource is not available, either from within London Councils or seconded from boroughs, additional third party or professional costs may be incurred. It is anticipated that these costs will be analysed in due course once the key roles have been more fully defined and the availability of suitable internal resources have been considered.

21. The fact that the boroughs will have a significant role both at the level of the ACS Operator and as investors in the ACS means that the FCA will require a robust conflicts of interest policy to be in place.

Investment manager selection and asset allocation

22. There are two key areas of responsibility which will allow boroughs to select the investments they wish to make. Following consultation with boroughs, the ACS Operator will offer a number of mandates to investors and will select a number of managers for this. The final decision over the selection of managers rests with the board of directors of the ACS Operator. The decision regarding asset allocation and whether to invest in the mandates being offered will be at the full discretion of each borough.

23. It is proposed that investment manager selection would be undertaken by an investment advisory team of the ACS Operator as described in paragraph 17 above which would report into the board of directors. There are a range of options for how this is set up, as the team can comprise elected Councillors, officers, and external hires if required. The preferred composition of this group would be decided in due course, but it is expected to be a mix of elected Councillors and officers, probably 6 to 8 in number. The majority of the roles on this group are expected to be part time although as more assets are added to the ACS and additional mandates and alternative investments are added, some of these roles may become full-time.

24. Once the ACS itself is established, it would be at the discretion of the boroughs whether they choose to invest in any or all of the ACS sub-funds. In order to allow individual borough to decide asset allocations between managers, the assumption is that the fund structure will be an umbrella fund, with each sub-fund having a specific investment mandate and investment manager. If a borough decides to invest in a particular mandate, they would simply acquire units in the relevant sub-fund. Please see Appendix A for a visual representation of this structure.

Legal and regulatory considerations

25. This section sets out some of the legal and regulatory considerations in connection with the set-up of the ACS Operator and the ACS, and sets out a timeline for achieving this.

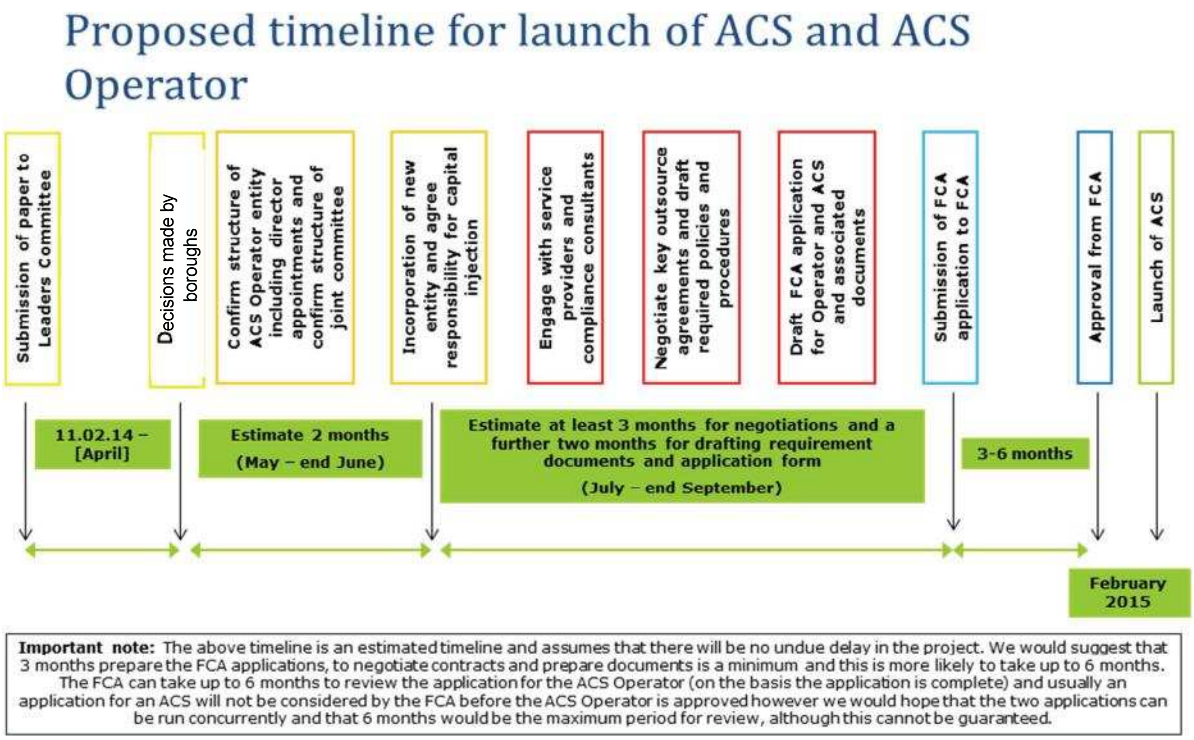
26. The ACS will require a Financial Conduct Authority (FCA) regulated ACS Operator to be established. Typically this is in the form of a limited liability company, which is proposed here. The ACS Operator and the ACS are heavily regulated. There is a separate authorisation process for each of them, involving different divisions of the FCA. The process for the authorisation of the ACS Operator requires detailed information to be supplied in particular around the qualifications of the board and key employees, their ability to carry out the key operational functions or supervise delegates, financial requirements etc. The form requires detailed information. The authorisation process can take between 6 and 12 months. As this application is for local authorities it is hoped that the application for the ACS operator and the ACS would be run concurrently by the FCA and we would hope the authorisation process would take nearer to six months than twelve, however this cannot be guaranteed.

27. The board of directors and employees of the ACS Operator will be responsible for the overall operation of the ACS. In order to meet these obligations it will need to appoint a number of external service providers, including the administrator, the registrar and transfer agent and investment managers. These appointments will need to be reasonably advanced to submit detail and draft documents to the FCA at the time of the application for authorisation.

28. In addition to the corporate entity being authorised individuals performing certain functions as described in this paper also require personal approval by the FCA.

29. We have set out below a proposed timetable for the launch of the ACS Operator and the ACS. This is subject to change and dependent on a number of factors, such as consideration by Leaders' Committee, relevant decisions being taken by the boroughs wishing to participate in the arrangements, selection of key personnel and negotiation of key contracts.

Fig 2. Proposed timetable for launch



30. The proposed timeline emphasises when certain decisions will need to be made. For example the fund mandates and strategies, and you will also note that certain service providers will need to be identified shortly following the incorporation of the ACS Operator entity, so that key commercial terms and service levels can be agreed. As discussed further below, the FCA application forms require in depth detail and draft documents which will take time to agree and complete and as such it is critical to consider these factors at the outset.

31. During the ACS establishment process, some regulatory clarifications will be required although it is not currently expected that there will be any material difficulties. In

particular, it will be important to confirm that a borough will be able to invest substantially all of its pension assets in a single ACS vehicle. Restrictions currently apply to certain collective investment vehicles. Whilst specific reference to ACSs is not made it will be important to ensure that the legislation is either amended or made clear that ACSs (and possibly other collective investment vehicles) which are operated by local authorities are carved out from these restrictions.

Capital requirements of the ACS Operator

32. Initially the ACS Operator will only require minimal share capital and, as such, it is recommended that each borough that wishes to proceed will acquire £1 of share capital in the company.

33. Immediately before the ACS Operator receives regulatory approval (expected to be 4th quarter 2014, see timetable comments at paragraph 30), it will require capital of c. £100,000. The calculation of regulatory capital is complex, and depends on a variety of factors, including the expected fixed overheads of the ACS Operator.

34. It is proposed that the c. £100,000 of ACS capital would be contributed by those boroughs which choose to move forward with the ACS in Autumn – so for example if 10 boroughs decided to proceed with the ACS in Autumn, this would require a capital contribution of £10,000 per borough. It should be noted that this contribution is an investment rather than an expense as this capital would be invested in liquid assets such as gilts rather than being used to pay expenses.

35. Once the ACS starts receiving investments, the ACS Operator will require additional capital, which may be c.2 to 3 basis points of assets invested in the ACS (for £5bn of assets invested in the ACS, the ACS Operator would require capital of £1m to £1.5m). This capital is broadly required at the point in time when the assets under management are due to increase. The total required regulatory capital of an ACS Operator will not exceed 10m euros.

36. Once boroughs choose to invest pension assets in the ACS, it is proposed that they would contribute capital to the ACS Operator in proportion to the assets invested. It is not expected that this should materially impact any return to the boroughs as the funds invested could be from existing pension assets which are currently invested in gilts or similar investments. As such the borough could retain exactly the same profile for its pension investments except that a very small proportion of their assets invested via gilts would be held indirectly through the ACS Operator rather than directly as at present. The precise capital requirements, and the mechanism for the contribution of this capital, will be considered in more detail in the next phase of the project.

37. It should be noted that boroughs who contribute £1 of share capital now will be under no obligation to make any further capital payments to the ACS operator. To the extent a borough takes a subsequent decision to invest in the ACS, it is proposed the borough would at that point invest further capital.

Financial Case

38. Having considered the potential structure and process for establishment, the following sections consider the financial case in more detail. There are a number of areas to

consider. Firstly the potential financial benefits of the ACS, and then the potential costs. These are considered in more detail below. It is clear that, based on the expected savings previously identified, forecast costs should be comfortably covered by savings in reduced management fees.

Financial benefits

39. The 33 London boroughs currently have over £20bn of pension assets under management. Previous work undertaken by PwC estimated savings in the region of £120m per annum from the creation of a CIV, provided there was close to full participation by authorities. Costs of running the ACS were estimated to be between 1 and 5 basis points (0.01% to 0.05%) of assets under management with the estimated costs, for full participation from all 33 London local authorities, estimated to be £4.8m per annum. At lower levels of participation, both the financial benefits and the costs would reduce. More work has now been undertaken on potential costs and benefits, based on high level assumptions, and these are summarised in the table below. It is clear that, based on the expected savings previously identified, forecast costs should be comfortably covered by savings in reduced management fees.

40. The primary cost savings previously identified were in respect of lower investment management fees, and improved performance. Further work since then indicates that there may be further savings in other areas. For example, when investing in a third party fund, it is likely that income from activities such as stock lending and foreign exchange will be earned, however may not be passed on to the boroughs and their pension investments to the same level as could be possible in the ACS. It has been estimated that the income from these activities could be in the region of 10 to 20 basis points. There is no current information available about the level of return that is currently allocated to boroughs in relation to their existing pension investments.

41. Additional analysis of costs has been undertaken since the PwC report. The broad conclusion of this analysis is that, depending on the level of participation, the marginal costs for investing in the ACS are likely to be in the middle of the original 1 to 5 basis point estimate and that there are potential additional savings that could be made.

42. A reasonable minimum target size of assets management for the ACS is considered to be in the range of £5bn of assets. This is based on work undertaken by the PWG, which shows that there are a number of boroughs who currently have very similar investment mandates with exactly the same investment managers. This research suggests that if 6 of the largest similar mandates with identical investment managers across a range of passive and active equity and bond mandates were selected in the ACS, scale of around £3bn could be achieved without any individual borough pension funds materially changing their currently selected mandates or manager. On the assumption that a number of other London boroughs would also be minded to invest in the ACS if it offered these mandates and given the initial interest expressed by boroughs in participating, a minimum target size of £5bn appears a reasonable assumption.

43. Indicative costs and potential savings are set out in the table below, for assets under management of £24bn, £10bn, and the minimum target size of £5bn explained at paragraph 42.

Fig 3. Summary of potential savings and costs

	Assets under management £24bn £ 000's	Assets under management £10bn £000's	Assets under management £5bn £ 000's
Expected savings per annum(1)			
Investment management fees - 15 bps	36,000	15,000	7,500
Improved performance - 35 bps	84,000	35,000	17,500
Total expected savings	**120,000**	**50,000**	**25,000**
On-going Costs per annum(2)			
Custody costs			
Custody costs (at 3.5bp, 4bp and 5bp)	(8,400)	(4,000)	(2,500)
Incurred in existing third party funds (3)	3,600	1,500	750
Net Custody Cost	(4,800)	(2,500)	(1,750)
Other Costs			
Salaries –e.g. COO/Admin	(400)	(400)	(400)
- Audit/advice	(200)	(150)	(100)
- Offices/expenses	(200)	(200)	(200)
- Misc. Advisory	(500)	(400)	(300)
Total On-going Costs	**(6,100)**	**(3,650)**	**(2,750)**
Establishment costs (2)(3)			
- Transition advisory including custody selection	(700)	(500)	(400)
- Other misc. fund advisory	(500)	(500)	(500)
- Legal, regulatory, and financial advice (funded already)	(600)	(600)	(600)
Total Establishment Costs	**(1,700)**	**(1,500)**	**(1,400)**

Notes

(1) These savings are as previously reported. They have been allocated on a straight-line basis for assets under management less than £24bn. This is an assumption made for simplicity and any real savings may well be less and will depend on types of mandate, asset mix, etc. There are also other potential areas where financial benefits may arise, such as increased income from activities such as stock lending, which have not been quantified within the above.

(2) All costs (other than custody costs) are estimated on very high level assumptions and may not reflect final costs.

(3) For "other costs" and "Establishment costs", some of these expenses would be incurred in existing investments or on changes of manager/investment. No attempt has been made to estimate these existing costs to date.

Custody costs

44. The main cost associated with running the ACS is from the custody of the assets. Custody costs are calculated as a basis point fee on the amount of assets, with the basis point fee reducing on a sliding scale as the amount of assets under custody increases.

45. In order to consider potential costs, assumptions regarding the potential value of the fund and number of sub-funds and investors have been made. These consider 3 possible scenarios based on the most commonly used asset classes, which are set out below. The assumptions used are not recommendations and are purely for illustration purposes for the business model:

    - sub-funds representing the most frequently used asset classes with minimal uptake by London local authorities investing 50% of total value in these asset classes into the fund,
    - broader range of sub-fund asset classes with a third of London local authorities investing 50% of total value in these asset classes into the fund,
    - all London local authorities investing 75% of total value in these asset classes into the fund.

46. Based on the above, the indicative cost of running the fund may be as follows:

    - 5 investors in 4 sub-funds (made up of mix of passive and active, global equity and UK equity) total £1bn, up to 10bps/minimum charge circa £500k per annum,
    - 11 investors in 10 sub-funds (made up of mix of passive and active, global equity, UK equity, global bonds, & alternatives) total £6bn, up to 5 basis points,
    - 33 investors in 15 sub-funds (made up of mix of passive and active, global equity, UK equity, global bonds, UK bonds & alternatives) total £14bn, up to 3.5 basis points.

47. These costs include Fund Administration (Transfer Agency and Fund Accounting), Depositary and Custody. These costs would reduce where additional services e.g. a proportion of cash, foreign exchange and Securities Lending services are also conducted by the appointed Custodian (which is standard with London boroughs existing custody arrangements). Other factors that feed into the cost consideration include the frequency of investor dealing and frequency of valuation points. It should also be noted that Fund Accounting fees typically operate on a sliding scale with minimum fees per sub-fund, therefore the larger each sub-fund in terms of value the more cost effective.

48. In terms of a cost-benefit analysis, it is important to note that borough pension funds already pay custody fees either directly for existing segregated mandates or indirectly in third party fund investments. Accordingly, the cost-benefit analysis needs to look at the amount by which the custody costs that would be incurred from investing in an ACS exceed current custody costs borne by the boroughs on their existing investments.

49. In relation to existing segregated mandates, it is likely that savings would be achieved through moving such mandates to an ACS as this would reduce custody costs. This is

because most existing segregated mandates are relatively small and accordingly consolidating these mandates in the ACS should increase the amount invested in each mandate which in turn would result in a lower basis point custody charge.

50. In relation to existing third party funds, the cost-benefit analysis is more complex because it is difficult to determine the custody fees that are payable by the investment managers that have established these funds as such numbers are not always publicly available. An estimate of these costs would be in the 1 to 2 basis point range.

51. Based on this analysis, it appears that for higher levels of participation the costs will be lower than previously anticipated. For very low levels of participation (e.g. £1bn) the costs could be higher than the 5 basis point charge previously anticipated. Even at a £1bn level of participation, there may well be financial benefits associated with establishing an ACS but this level of participation is below the minimum level that might reasonably be expected.

52. At a level of assets of £5bn the additional custody costs would be expected to be in the range of 3 to 4 basis points (or £1.5 to £2m per annum), being an ACS custody cost of c.5 basis points less the 1 to 2 basis point charge which would have been incurred on existing investments.

Other costs and benefits

53. Other on-going costs of the ACS are likely to include staff costs, FCA fees, consultancy fees and administration costs including audit and taxation. These fees would be charged directly to the fund, as they would be now. Consultancy fees might include professional advice on investment manager selection. As this would be performed centrally at the ACS level rather than multiple times at individual borough level, it is likely that savings would be achieved in this regard. Admin costs would not be expected to be significant compared to the benefits identified.

54. In relation to staff costs, this is considered in more detail below but on the basis that it is expected that a majority of functions may not be full time and might be performed by existing local authority personnel, additional staff costs are not expected to be significant. For the purposes of the cost benefit analysis undertaken, an estimate of £400,000 per annum has been made. Practically, the roles which might be required are set out below.

Establishment costs

55. There will be a number of establishment costs incurred in setting up the fund. These will be one-off costs in the first year.

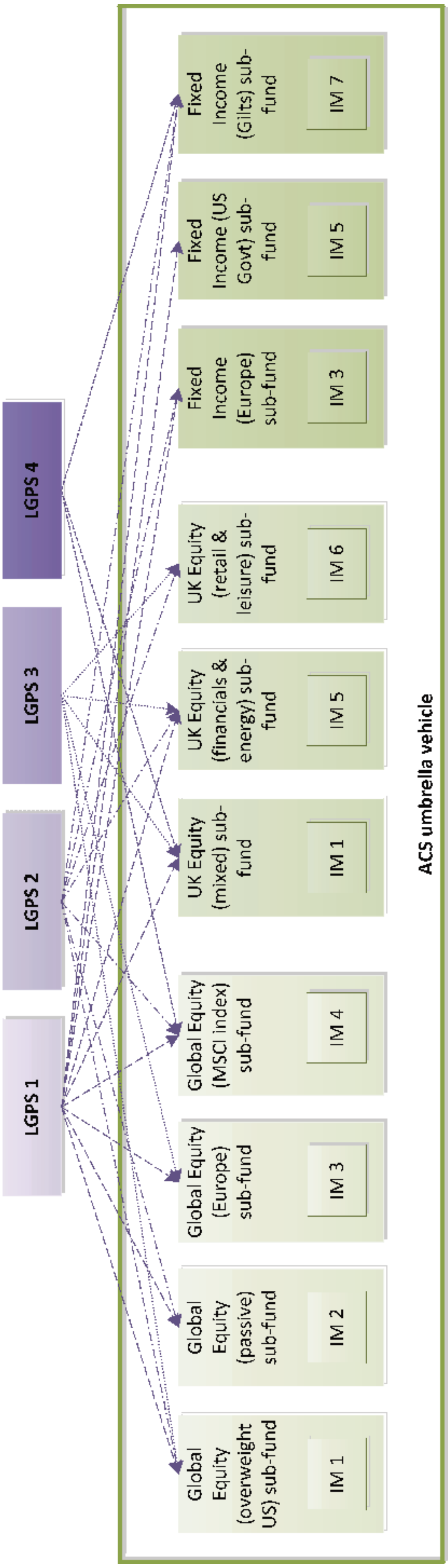
56. £625,000 has already been contributed to these costs by the boroughs, in order to engage professional advisors to perform the necessary financial and regulatory work. It is currently expected that this work will be performed within this existing budget.

57. As the project progresses, additional professional fees are likely to be incurred, for example to assist in training relevant individuals on their regulatory roles and to assist in the development of procedure manuals. It will become clearer in due course where costs may arise in this regard.

58. The transition of assets into the fund will also need to be considered, as assets are moved from existing managers to new managers appointed to the ACS. To a large extent, boroughs already incur similar costs as they transition assets to different managers in the ordinary course of their pension activities. As such these costs may well simply offset existing costs incurred by boroughs although clearly this depends on the level of fees currently charged and the number of transitions. Until further decisions are taken on the mandates that will be launched in the ACS, it is difficult to estimate accurately what these costs might be. An estimate of advisory fees required in connection with this transition management is included within the table, and is based on the experience of advisors on similar projects. It should be noted that the boroughs currently have regular manager transitions, and as such the costs of transition from setting up the ACS should result in lower annual transition costs going forwards.

59. From a tax perspective, the transfer of UK securities into an ACS should not be subject to UK stamp duty reserve tax (SDRT), and a tax clearance can be obtained in advance to give comfort. It is envisaged that the costs of transition would be borne by the pension funds who are moving their assets into the fund, and the cost would depend on the assets being moved. Due diligence will be needed for individual pension funds should they choose to invest, to consider the most appropriate way to transition into the fund.

Appendix A - Indicative ACS umbrella structure



This page is intentionally left blank

Appendix 2 Timing and quantum of regulatory capital requirements for London Councils' Operator of the Authorised Contractual Scheme

Introduction

This document sets out information as to the estimated amount and timing of the regulatory capital requirements for the Operator of the Authorised Contractual Scheme ('The Operator'). It follows on from the information set out in the Pension Working Groups report to Leaders Committee dated 11 February 2014, and specifically the information on the capital requirements of the Operator set out at paragraphs 14 to 18.

As noted in that paper, this contribution is an investment rather than an expense as this capital would be invested in liquid assets such as gilts rather than being used to pay expenses. Once the fund is established, expenses of the operator will be charged to the fund. It is proposed that boroughs who invest pension assets in the ACS, would contribute capital to the ACS Operator in proportion to the assets invested. It is not expected that this should materially impact any return to the boroughs as it is proposed that the funds invested could be invested in gilts or similar investments. As such the borough fund could retain exactly the same investment profile except that a very small proportion of its assets invested via gilts would be held indirectly through the ACS Operator rather than directly as at present.

Summary

The amount of capital that will be required by the Operator will change over time. This is because there is a formula that determines the amount of capital that will be required and this formula is a function of various commercial factors such as the expenditure of the Operator and the levels of assets under management. As the activity levels of the Operator increase, so the amount of capital required will increase.

There are four important considerations that need to be addressed. These are as follows:

(i) The amount of capital that will be required and the timing by which this capital is required;
(ii) The time by which capital will be required from boroughs;
(iii) The mechanism for determining how much each borough will be required to contribute; and
(iv) The extent to which capital is impacted by profits and losses made by the Operator.

Each of these areas is considered in more detail below.

(i) <u>The amount of capital that will be required</u>

The formula for determining the amount of capital required is determined by regulation and has a number of variables. The detailed formula is set out at Appendix B. However, it is probably easiest to understand by considering how it applies to the Operator as the Operator's activities evolve over time.

The normal sequence of events in an Operator's life can be described as:

- established as an unregulated company;
- becoming authorised as a regulated Operator;
- appointed to manage an ACS fund; and
- Investors will start to invest.

Appendix A contains a graph that plots the size of the ACS against the capital requirements of the Operator and provides a link to each of the phases discussed in the body of this document.

Each of these phases in the Operator's life has a slightly different regulatory requirement and these are considered below.

Prior to the Operator being regulated there is no regulatory capital requirement and accordingly the Operator can initially be established with minimal share capital (e.g. £1 per shareholding local authority).

Once the Operator is about to be authorised it will require minimal share capital of €125,000.

Once the Operator starts to manage the ACS fund, the formula set out at Appendix B applies. In broad terms, this formula determines that capital is required at the higher of two different numbers. The first number is a function of the fixed costs of the Operator and the second number is a function (approximately 3 basis points) of the assets under management of the ACS fund.

Accordingly, once the Operator becomes a manager of the ACS fund but before there are any assets under management, the Operator will require some regulatory capital by reference to its fixed costs.

As the ACS starts to increase the amount of assets under management there will come a tipping point at which the relevant part of the formula will be a function of the assets under management rather than being a function of fixed costs. The timing of this tipping point will vary depending on the amount of fixed costs of the Operator. The technical position is set out in further detail at Appendices A and B.

(ii) <u>The time by which capital will be required from boroughs</u>

The regulatory capital requirements described above are minimum requirements. In deciding the actual amounts of capital to be contributed and the timing of such contributions, the specific facts and circumstances of the Operator needs to be considered. For example, it makes sense to have some margin of excess capital to deal with potential movements in investment markets. Similarly, it would be inefficient to have to continually inject new capital every time an investor marginally increases their investment in an ACS.

In relation to the Operator, the key timing points are likely to be the initial authorisation of the Operator and then the date on which the Operator goes live in terms of managing the ACS fund.

The Operator is likely to be authorised in late 2014 and accordingly at this point, regulatory capital of €125,000 will be required. On the assumption that at least ten boroughs are participating in the CIV, this would amount to a capital requirement of no more than €12,500 per borough. The regulation sets this initial amount in Euros, whereas subsequent amounts are a based on fixed costs of the Operator or the amounts of assets under management, both of which are denominated in Pounds Sterling.

The second key date is the date on which the Operator becomes the manager of the ACS fund. Although at this date there would be no assets under management and accordingly the only capital requirement would be a function of the fixed expenses of the Operator, the current working assumption is that capital would be subscribed at this point which would satisfy the regulatory capital requirements for a given level of assets under management. The logic for this approach is that once the ACS fund comes into existence, it will only be a matter of a few months before the pension funds invest into it. Accordingly, it would be more efficient to establish capital requirements at this point that anticipates the likely levels of investment rather than having to continually request additional capital as investments are made.

This approach also gives boroughs a clear expectation of the level of capital required on which they can make decisions rather than providing a more complex series of potential capital requirements with different time frames. The amount of capital required would be in the region of 3 basis points of assets under management. This means, for example, that for an expected assets size of £3bn, the capital requirement would be £900k. Accordingly, based on ten boroughs participating, the level of capital required would be in the region of £90,000 per borough. This capital is likely to be required in the first quarter of 2015. As noted above, this contribution is an investment rather than an expense as this capital would be invested in liquid assets such as gilts.

There is a maximum capital requirement of around €10m.

(iii) <u>The mechanism for determining how much each borough will be required to contribute.</u>

It will be important that the requirement to invest capital in the Operator is spread fairly across participating boroughs. The potential recommendation in this regard will depend on a number of factors such as how many boroughs choose to participate initially in the ACS, together with the likely quantum of assets to be invested in the fund. Any approach will need to take into account the relative size of potential investments from different boroughs together with the possibility that new boroughs may participate over time and existing boroughs may increase or decrease their investments in the ACS fund. This will be considered by the Pensions Working Group as part of the next phase of the project. It is expected that over time the capital contribution required from the borough will be in proportion to the level of assets that each borough has invested.

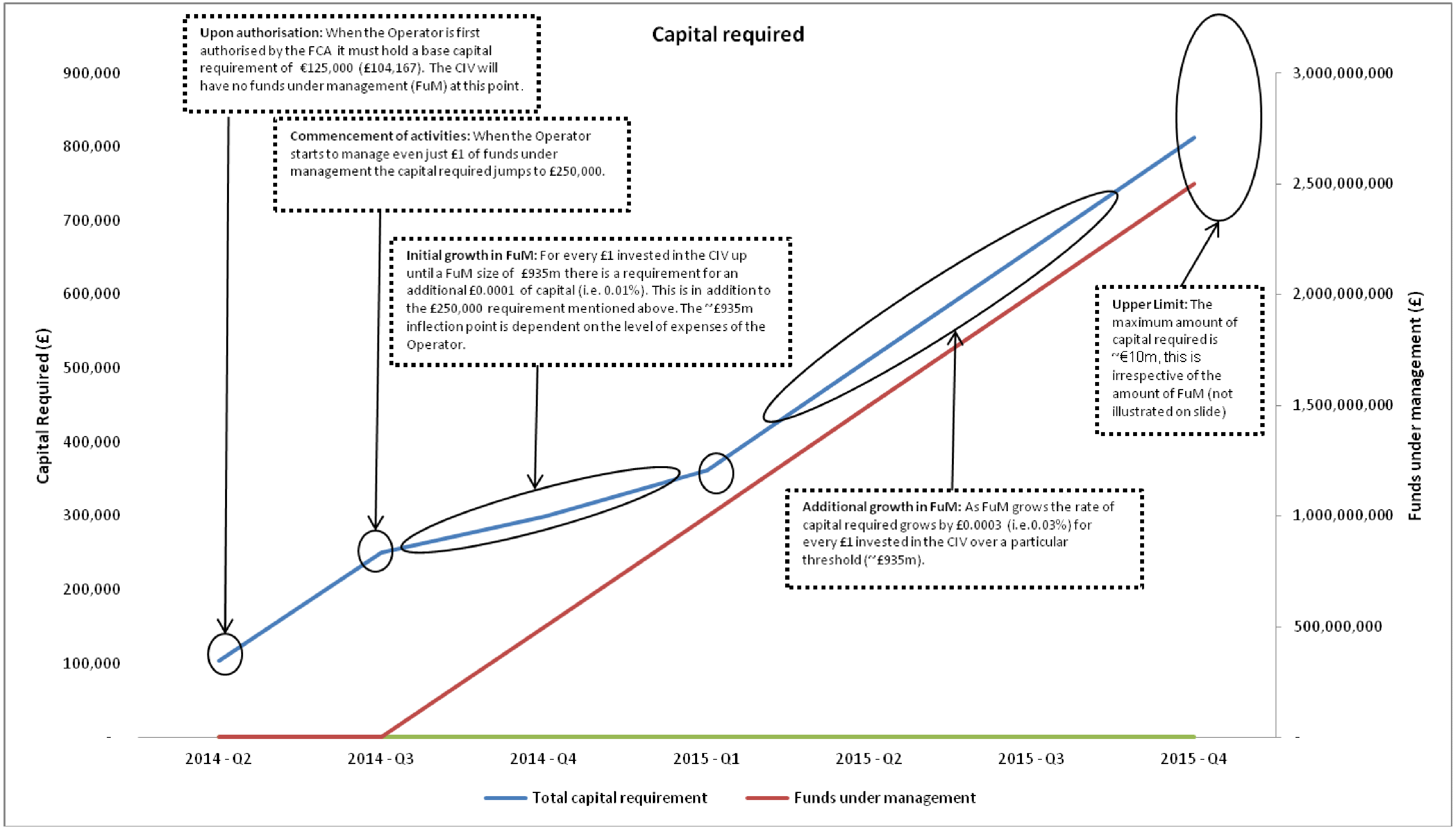
One of the over-arching principles of the ACS is that boroughs should be free to disinvest from the ACS as they choose. In this regard, the process by which boroughs can have any ‘excess’ capital returned to them is being considered. The intention would be that following a disinvestment, capital would be returned, but it is necessary to consider regulatory restrictions that serve to protect the ACS and operator having regulatory capital withdrawn indiscriminately at the sole discretion of investors.

(iv) <u>The extent to which capital is impacted by profits and losses made by the Operator</u>

It is not expected that over time the Operator will make any profits or losses. It will charge a fee to the fund to cover its operating costs. Depending on timing, there may be an initial loss, and then conversely a small profit at a later date, however over time minimal net profit is expected to arise. To the extent that initially cash paid out from total expenses are higher than income received / accrued, then additional capital may be required and this will be factored into the initial calculations in due course.

In the early months, it is expected that expenses of the Operator will exceed revenues. The intention is that these costs will ultimately be borne by investors in the fund in a manner which results in a fair apportionment and such that they are not unfairly borne by the initial shareholders of the Operator.

Appendix A – Graphical illustration



Appendix B: Regulatory capital under AIFMD for a Collective Portfolio Management Firm (CPM firm)

Introduction

This Appendix sets out information as to the regulatory capital that the Operator of an Authorised Contractual Scheme (Operator) would be required to hold under the Alternative Investment Fund Managers Directive (AIFMD). Our working assumption is that the Operator will be a full-scope UK AIFM because the Authorised Contractual Scheme (ACS) will be above €500m. We expect that Operator will be a Collective Portfolio Management firms (CPM), which means that you will not be providing services under the Markets in Financial Instruments Directive (MiFID). CPM firms are subject to IPRU (INV) chapter 11 and this note summarises its requirements in relation to the capital the Operator will need to hold.

This note focuses on the quantity of capital that the Operator will need but not its constituent parts i.e. share capital, subordinated loans, perpetual preference share capital, etc. In general the capital will need to be comprised of Tier 1 / Tier 2 capital (Appendix B). If subordinated loans or perpetual preference share capital meet certain conditions they can be included as Tier 2 capital, but only up to a maximum of 50% of Tier 1 capital, which broadly speaking means ordinary shares, retained earnings and share premium accounts.

Summary of provisions of Chapter 11 of IPRU-INV

1. *Initial authorisation* base capital requirement

Term	Requirement	IPRU-INV
Base capital requirement	**When a CPM firm first receives authorisation** it must hold initial capital of no less than the applicable base capital requirement. The Operator's base capital requirement will be €125,000.	11.2.1R(1), 11.3.1R(1)

2. *On-going* own funds and liquid assets requirement

Term	Requirement	IPRU-INV
Overarching	The Operator must maintain **at all times** **Own Funds** which equal or exceed the higher of (A+B) or C, plus D (see additional definitions, highlighted in bold, on next page) and **Liquid Assets** which equal or exceed the higher of (B) or C, plus D.	11.2.1(2) & (3)
A – Base capital requirement	The base capital requirement (i.e. €125,000)	
B - FuM requirement	0.02% of the amount by which the **funds under management** exceed €250,000,000.	11.2.1(2)a(i), 11.3.2R
C – Fixed overhead requirement	One quarter (13/52) of the Operator's **relevant fixed expenditure**.	11.2.1(2)a(ii), 11.3.3A EU
D – Professional negligence requirement	In addition the Operator must also hold **own funds** to cover professional liability risks set out in article 12 of the AIFMD level 2 regulation. This can be done in two ways, either via an insurance contract (where there will be no own funds requirement for the Operator) or via additional own funds.	11.2.1R(2)b, 11.3.11 G, 11.3.12 EU, 11.3.14 EU

Term	Requirement	IPRU-INV
	If the Operator holds additional **own funds** rather than enter into insurance contract the requirement is to hold additional **own funds** at least equal to 0.01% of the value of the **portfolios of AIFs managed**. If you wanted to instead have a contract of insurance, you will need to ensure it addresses the risks set out in IPRU-INV 11.3.12 EU.	

Term	Definition	IPRU-INV
Own funds	Own funds means the sum of Tier 1 capital and Tier 2 capital in accordance with the **Capital Requirements Regulation**. A very brief summary of Tier 1 capital is set out in Appendix B below.	FCA Glossary
Liquid Assets	Liquid Assets are: • readily convertible to cash within one month; and • Have not been invested in speculative positions. Examples of liquid assets include cash, readily realisable investments that are not held for short-term resale, and debtors. Other assets may also meet the definition but this will need to be assessed on a case by case basis.	11.3.17R, 11.3.18 G
Funds under management	The sum of the absolute value of all assets of all funds managed by the firm shall be the sum of the absolute value of all assets of all AIFs managed by the AIFM, including assets acquired through use of leverage, whereby derivative instruments shall be valued at their market value. This includes funds where the firm has delegated the management function but excludes funds that it is managing as a delegate.	FCA Glossary (as proposed by FCA Quarterly Consultation)
Relevant fixed expenditure	*Calculation of relevant expenditure*: this should be in accordance Supplementing Regulation (EU) No 575/2013 of the European Parliament and of the Council with regard to regulatory technical standards for Own Funds Requirements for Investment Firms based on Fixed Overheads. See page 10 of the **RTS**	11.3.3A EU
portfolios of AIFs managed	*Calculation of portfolios of AIFs managed:* The value of the portfolios of AIFs managed shall be the sum of the absolute value of all assets of all AIFs managed by the AIFM, including assets acquired through use of leverage, whereby derivative instruments shall be valued at their market value. This should be recalculated at the end of each financial year i.e. for FY14 you would use the portfolio of AIFs as at the end of FY 13 as your calculation base.	11.3.14 EU