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.

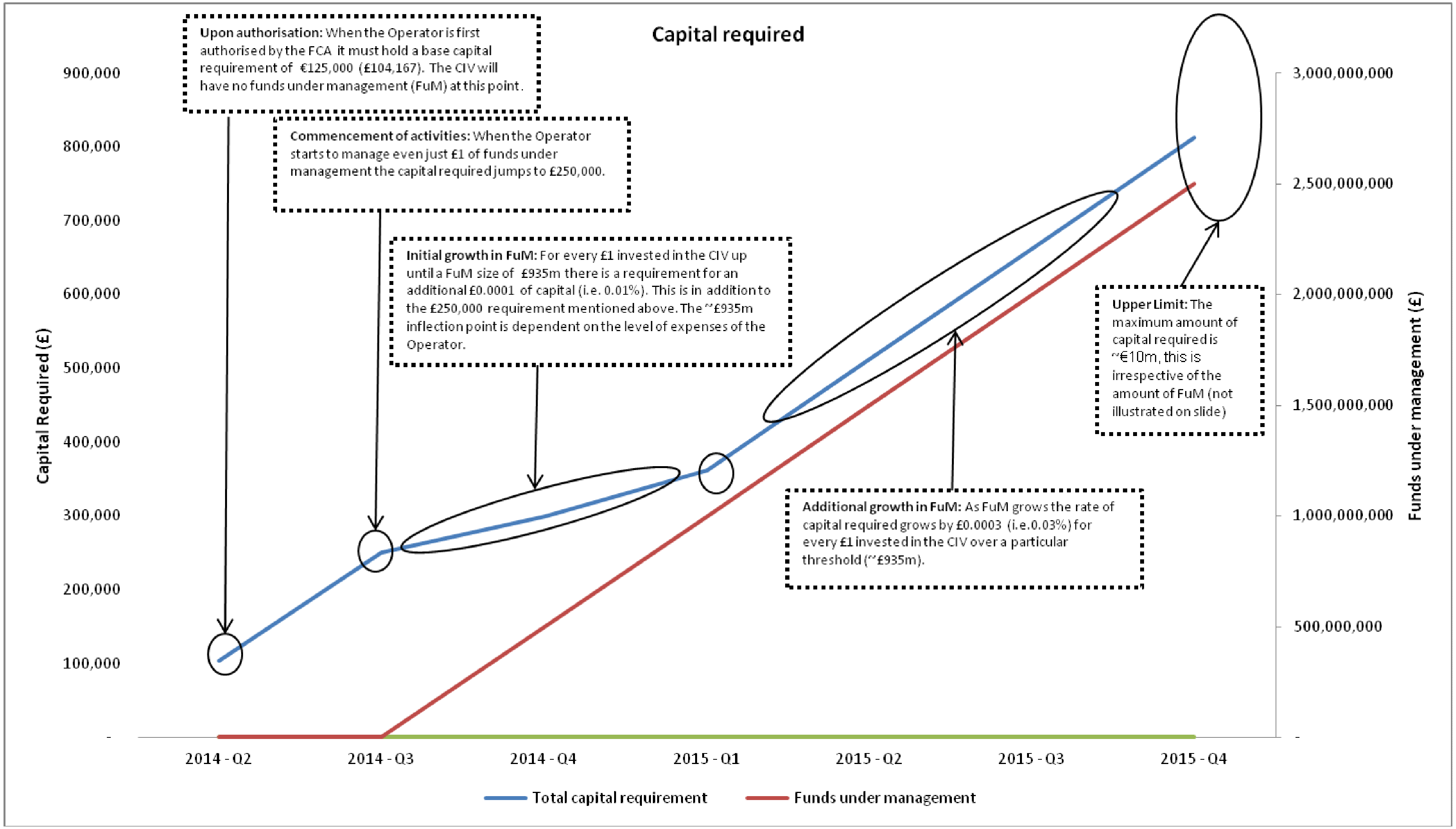
One of the over-arching principles of the ACS is that boroughs should be free to disinvest from the ACS as they choose. In this regard, the process by which boroughs can have any ‘excess’ capital returned to them is being considered. The intention would be that following a disinvestment, capital would 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