Introduction

Pooling of the Local Government Pension Schemes (LGPS) continues to gain momentum. The initiative, announced in the summer of 2015 by former Chancellor of the Exchequer George Osborne, proposed that the 89 pension funds comprising the England and Wales LGPS market be consolidated into six larger pools. In line with the deadlines published by the UK government, detailed proposals from eight pools were submitted to the Department for Communities and Local Government (DCLG) in July 2016. The government requires the pools to be operational by April 2018 and ahead of this rapidly approaching deadline the LGPS have been working diligently to develop and implement appropriate operating models for the newly formed pools.

In its paper entitled, “LGPS: Investment Reform Criteria and Guidance”, published in November 2015, the government identified four key criteria that the LGPS are required to deliver through the pooling initiative. The pools will need to achieve benefits of scale, put in place strong governance and decision making frameworks, reduce costs and deliver excellent value for money, and they will need to demonstrate improved capacity to invest in infrastructure.

The government proposed that each pool will manage a minimum of £25bn and that the benefit this increased scale brings to the LGPS will result in cost saving opportunities across a number of areas. For example, the Project Pool summary report¹, a collaborative effort between Hymans Robertson and 24 LGPS, estimated that the pools could realise annual savings of between £32m and £64m in active equity manager fees by year five. Opportunities for savings may also be achievable through consolidation of financial services related to the operational activities of the LGPS including custody, fund accounting, depositary and trustee, payments clearing and cash management services.

Putting in place robust governance and decision making frameworks could prove more challenging to develop and implement however. The pools will need to put in place a strong governance and oversight model which satisfies a large number of stakeholders across the participating schemes, as well as the Financial Conduct Authority (FCA) and the DCLG. In addition to this, further complexities arise from the impact different fund structures will have on the governance and oversight frameworks required.

With respect to infrastructure investment, there is evidence within the July 2016 submissions to the DCLG that suggests that the government will realise its goal to promote increased infrastructure investment from the LGPS. Additionally, the increased size of the pools coupled with a changing regulatory environment could enable diversification of investment into alternative asset classes and increased usage of over-the-counter (OTC) derivatives.

Broadly speaking the potential benefits of pooling the LGPS are clear, but in HSBC’s opinion the path to delivering these benefits will not be simple to navigate. The LGPS have access to guidance from multiple sources within the financial services industry which they may need to leverage further in the coming months as they undertake a complex journey into pooled structures.

The purpose of this paper is to provide an overview of the four key criteria of pooling and highlight some of the important considerations for the pools to help them achieve the objectives set by the Government.

1. Asset pool(s) that achieve the benefits of scale

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There has already been significant engagement with the consulting and financial services industries and this is expected to continue throughout 2017 as pools further shape and implement their target operating models.

2. Strong governance and decision making

One of the key criteria of the pooling initiative is for each pool to demonstrate that it will develop and implement a strong governance and oversight model ahead of the April 2018 deadline. The fund structure selected by the pools will shape the governance model and having reviewed various research and consultation papers, in addition to the July 2016 submissions, HSBC understands that the majority of pools will operate as Authorised Contractual Schemes (ACS).

An ACS is a regulated tax transparent fund structure and is an effective and flexible mechanism which allows pension schemes to simplify their operating mechanisms and pool assets. Established under the Finance Act 2013, an ACS structure is regulated under the EU’s Alternative Investment Fund Managers Directive (AIFMD) or Undertakings for Collective Investment in Transferable Securities (UCITS). An ACS is managed by a Financial Conduct Authority (FCA) regulated operator which will be responsible for the day to day management of the fund and for service provider selection. Each of the participating pension schemes will be represented on the board of the ACS.

The tax transparent nature of the ACS means that the LGPS schemes are taxed on the income received in the ACS as if it had received it directly. This allows the schemes to pool their assets into a fund whilst maintaining its advantageous tax treatment in certain markets. For instance, most collective investment funds pay 15% to 30% withholding tax on US sourced dividends. Investing via an ACS means that the schemes can receive these dividends gross, which prevents any negative impact on investment performance.

A smaller number of pools are instead opting for a segregated mandate approach, or managed account structure. This structure allows for listed assets to be held in segregated mandates. Pools opting for this approach are doing so with the belief that this is the most financially viable option, particularly in situations where external asset management mandates across the schemes have limited overlap. It is clear that not one structure can be identified as the correct model for all pools, but rather that the pools are tasked with identifying and implementing an optimum model based on the specificities of their own schemes.

Case Study

HSBC has direct experience of servicing ACS structures and was selected to work with one of the first and largest ACS structures launched in the UK. The client is a major UK insurance group that was seeking to establish a UK ACS as part of an initiative to improve investment performance.

There were 21 sub-funds running USD24 billion with equity, bond and derivative instrument holdings. There were approximately 150 investors across multiple legal entities. This exercise would be the first time a UK life company would hold equities and bonds through an ACS. It would also be the first time income equalisation would be applied to an ACS to support multiple taxable investors into the same share class without limitations. Finally, it would also mark the first-time creation of a multi-layer ACS, whereby multi-asset sub-funds of the ACS would invest in other sub-funds.

The project began in September 2013 and HSBC was selected as the sole service provider for depositary, custody, fund administration, transfer agency and middle office services in April 2014. A transition plan was subsequently agreed and an executive committee and governance structure was put in place with executive sponsors accountable for the transition. HSBC started testing the implementation programme in November 2014, and the ACS fund launched successfully in April 2015.

During the implementation process HSBC adopted a multi-stream programme plan, which it created and was approved by the client. An HSBC transition director was accountable for all of the streams. Key performance level targets were set. It was critical that operational processes and controls and operating model designs were established around areas such as IT, systems, data integration, telecommunications, infrastructure, internal and external communications, PMO and risk assurance, and migration plans.

The launch was successful and assets were transitioned into the new structure within three months. All aspects of the client’s requirements were met, and the project was considered a huge achievement. The client relationship remains strong and there have been no issues with implementation since the project was completed. This initiative set the benchmark for future transitions, evidenced by the fact that some of the principles agreed with HMRC have since set the tax law and guidance around upcoming ACS projects.

A number of lessons were learned from the transition. It is crucial to have clear, consistent requirements and ensure definition of terms are agreed upon by all parties. For example, challenges occurred when the same phrase may have been used by both parties but had different meanings. Organisations should create a clear, consistent data dictionary to ensure there is minimal confusion. A data dictionary can help map one party’s systems to the other.

One of the key success stories of this ACS launch was the close working relationship developed between HSBC and the insurance company at senior and working levels. This allowed for rapid resolution of design issues as and when they arose. It is advised that firms host joint workshops to boost collaboration and minimise any arbitrages in programme execution.
For pools selecting the ACS route, in our opinion the appointment of a robust trustee and depositary solution by its operator is critical to ensuring strong governance of the pool. Depositaries play an important role in providing independent oversight of the activities of fund managers in key areas such as unit pricing, dealing, portfolio valuation, CIPFA accounting, cash monitoring, and adherence to the regulations and any restrictions within their fund documentation. Given that the appointed depositary assumes various liabilities for financial instruments under its custody, strength of its balance sheet and its level of oversight at a pool, scheme and asset class level is absolutely critical. ACS operators should seek to appoint depositaries which have appropriate experience and are able to demonstrate expertise in servicing ACS clients.

Another consideration for LGPS and their trustees is the evolving regulatory landscape and the way in which these developments may impact investment strategies. For example, reforms to the LGPS Investment Regulations in 2016 now classify an investment to include dealing in financial futures, options and derivatives. In other words, from a regulatory standpoint the derivatives market is now potentially open to LGPS who have not historically had full access to these instruments.

Many corporate defined benefit pension schemes have been participants in the OTC derivatives market for more than a decade. Pension schemes initially entered the OTC market to hedge unrewarded risks using interest rate swaps and inflation swaps. This has since evolved with a number of pension schemes now utilising derivative products such as equity futures, total return swaps and options to complement their return generating strategies as well as to hedge their liabilities. Some of these products can be complex and the LGPS need to ensure that appropriate levels of resources and support are in place within the pools to implement derivatives-based strategies.

In-house OTC derivative execution also carries with it a number of operational challenges. These include documentation and collateral obligations under International Swaps and Derivatives Association (ISDA) agreements and Credit Support Annexes (CSAs) and the move towards mandatory clearing of OTC derivatives. The Basel Committee on Banking Supervision (BCBS) and International Organisation of Securities Commission’s (IOSCO) policy around uncleared bilateral OTC trades over a certain threshold will require pension funds to post variation margin from March 2017, and eventually initial margin. This will require impacted parties to make changes to their collateral management processes and potentially redraft ISDAs and CSAs. The operational impact of supporting daily margining should be considered by the pools.

There are also regulatory hurdles to clear before full use of derivatives by the pools becomes a certainty. The Markets in Financial Instruments Directive II (MiFID II) assigns ‘retail client’ status to local authorities, who under the previous rules were deemed to be ‘professional clients’. MiFID II retail investors will be prevented from entering into certain derivative transactions or investing into managers not considered suitable for non-professional investors. This would narrow the range of eligible investments which pools could gain exposure to. HSBC understands that certain pools are engaging with the FCA to appeal this outcome and to simplify the process to opt up to “professional client” status and thereby open up use of the full range of derivative products.

What is clear is that there are a number of elements to be considered by the LGPS when developing their governance and oversight structures and for assessing suitability of service provider relationships to support their chosen model.
3. Reduced Costs and Value for Money

Consolidation of the 89 LGPS into a smaller number of larger asset pools is intended to create cost efficiencies through economies of scale and the elimination of duplication in a number of areas. There will be significant near term cost associated with setting up the pooled fund structures, however findings from the findings of Project Pool summary report produced by Hymans Robertson and the 24 LGPS, estimates that the pooling initiatives could deliver savings between £190m and £330m per annum in the longer term.

The pools should benefit from partnering with service providers capable of supporting them in reducing upfront costs and longer term costs. HSBC believes that cost savings can be achieved in a number of key areas, including but not limited to the following.

Investment management

The pooling of the LGPS is an opportunity for the newly formed pools to consolidate providers across their schemes, rationalise external mandates within the new fund structures and with the benefit of scale exert pressure on providers to reduce fees. In addition, pooling of resources across schemes could result in pools moving to internalise or further develop existing internal asset management capabilities for certain, or in the future even all, asset classes. During the time of the initial government consultation on the structure of LGPS, Deloitte estimated that a move to passive investment could save £420m annually through a reduction in investment fees and reduced transaction costs.

In more traditional asset classes, investment managers are likely to witness continued movement from active towards passive investment in the drive to meet cost saving objectives. This may also stimulate a rise in the use smart beta and factor investing as two cost effective approaches that can potentially deliver above market capital weighted portfolio returns over the long-term. As a possible counter to this perhaps, bigger pools may allow for more cost effective delivery of more niche market strategies and therefore increase rather than lessen scheme choices.

This scale benefit might also enable increasingly important environmental, social and corporate governance (ESG) policies to be implemented more efficiently. In any case, pools will continue to seek out partnerships with investment management firms with clear long term strategies and solid track records to support them in meeting their ambitions, and they will do so from their strongest ever fee negotiation position.

Foreign exchange execution

FX execution costs can be reduced through netting and aggregating foreign exchange exposures. Custodians are able to net and offset transactions across multiple investment managers and custodians on behalf of their clients, thereby reducing the bid-offer spread and improving transparency around FX execution. HSBC believes that further cost efficiency can be realised by implementing a solution which nets and aggregates FX exposures across other pools, in addition to investment managers and custodians.

Payments clearing, liquidity and cash management

Cost savings may be achieved through the development of payments clearing and cash management solutions. Service providers can work with the pools to develop solutions which can automate cash management processes thereby allowing the pools to identify and consolidate cash positions in real time. These solutions will utilise tools and techniques including notional pooling, cash concentration, interest enhancement, and automated sweeps into selected investment vehicles.

Through use of these tools the pools will be able to automate the allocation and investment of excess cash into an array of money market funds which are selected to meet agreed security, liquidity and yield parameters. These cash management processes allow the pools to maintain daily liquidity for transactional purposes whilst optimising the investment of excess cash. Given that this could be managed at a pool level rather than at the scheme level the larger volumes could also facilitate savings through negotiation of preferable fee terms with banking providers.

Whilst the eight pools all stand to incur increased cost as they implement their preferred operating structures, service providers are well equipped to support the pools through traditional services such as securities lending to help offset some of these costs. A Securities Lending programme with the right governance and oversight and with the appropriate indemnification can generate incremental revenue returns from portfolio holdings that are otherwise sitting idle.

Enhanced automation and the utilisation of platforms for unit dealing, cash allocations and re-balancing could also demonstrate that “value for money” can be achieved not necessarily through reduction in costs but through operational efficiency. Service providers chosen to support the pools will need to have the flexibility and complexity built into these platforms to support the needs of the pools and their underlying funds.

Case Study: LGPS FX PLATFORM

HSBC has developed an automated FX pooling platform specifically for the LGPS which leverages the concepts behind existing investment manager and custodian FX netting products. Traditional products aim to provide efficiencies, oversight and transparency through netting FX transactions across a scheme’s investment managers. HSBC’s FX pooling platform takes this a step further and enables multiple LGPS funds to receive additional benefits by netting and aggregating amongst each other as well as across multiple custodians. This represents another opportunity for the LGPS to demonstrate collaboration and cooperation.

HSBC currently supports seven LGPS with its FX netting platform, accounting for 18 percent of the total LGPS assets. Approximately USD250k in cost savings directly attributable to the cross scheme netting have been delivered to the LGPS since its inception, notwithstanding further reduced costs due to the competitive pricing. An average netting benefit of 25 percent has been achieved for the LGPS on the platform.

Risk management and transparency were fundamental considerations in the development of the product for HSBC. Counterparty risk is reduced as the schemes involved do not take any exposure to each other. HSBC, one of the highest rated and best capitalised banks in the world, will act as the counterparty in each trade, whilst maintaining the confidentiality of each underlying position.

HSBC’s LGPS FX platform executes orders against the WMR/Reuters (WMR) benchmark 4pm London fix. The costs of execution are based on a guaranteed and transparent synthetic risk spread around the WMR “Mid” rate thus removing the BID/OFFER spread. The process allows the LGPS to have full transparency of the spread that is based on the mid-price, enabling it to have improved control over FX execution costs. This allows the LGPS to demonstrate that it has effective FX execution governance in place.

The FX pooling platform is fully automated and delivers Straight Through Processing (STP) connectivity across custodians. Automatic reporting to the individual schemes satisfies regulatory requirements and quarterly netting benefit reports are produced for the schemes which detail exact cost savings delivered over the period.

The concept of a pooling platform has been rapidly gaining popularity within and beyond the LGPS community. The consistent benefits of netting across schemes has attracted the interest of corporate pension schemes where HSBC is now coordinating efforts to replicate the LGPS platform for that sector. Collaborations between HSBC and partnering schemes will lead to additional efficiencies for all beneficiaries, as the platform continues to develop and grow in scope.
4. An improved capacity to invest in infrastructure

Promoting increased investment in domestic infrastructure projects is of paramount importance to the UK government. The UK Treasury announced in the 2016 Autumn Statement that £23bn would be allocated to infrastructure projects covering research and development, housing, roads, telecommunications transport, internet and energy projects. Creating an environment which also mobilises existing LGPS assets to invest in infrastructure through pooling fits well with this government objective. It should be noted that there is no requirement from the UK government for investment to be restricted to UK projects only, nor should there be given that this will have an impact on portfolio risk concentration.

There are also commercial drivers in the push towards infrastructure investment. A difficult economic environment with increased equity market volatility and depressed interest rates has meant that pension funds, including the LGPS, are considering alternative higher yielding investment opportunities in order to meet their liabilities whose present value continues to grow as a result of persistently low global interest rates and increasing life expectancy. Infrastructure is considered as a long term investment which can provide steady cash flows to the LGPS to support them with matching these growing liabilities. There are a number of other potential benefits of investing in infrastructure. It is an asset class which can weather inflationary risks effectively as revenue streams will generally rise in line with inflation. Higher returns have been achieved by investing in infrastructure, but this is not guaranteed. It is worth noting that large capital inflows and increased competition to invest in this asset class in recent years has meant that returns have diminished markedly. Consequently, it is not possible to make a reliable prediction about future returns.

There are also risks which the LGPS will need to be familiar with if they choose to allocate assets to this investment class. For example, infrastructure projects can be susceptible to political and regulatory intervention and change, such as a subsidy regime for renewable power generation. Another consideration is that infrastructure investments are typically illiquid assets and in certain cases this could mean that an LGPS investor may not be able to realise a full valuation of an asset in the event of a fire sale.

Due to the size of committed investment required to participate in many direct infrastructure projects, smaller LGPS in particular have historically had limited access to this asset class. The scale benefits achieved through pooling should facilitate increased direct investment into infrastructure for these LGPS. This is supported by the pool submissions which indicated that many pools could be targeting an allocation of 5-10% of total assets to direct and indirect infrastructure investments.

Eight independent LGPS infrastructure players may not be the optimum model for direct infrastructure investment. Further scale and synergies can be achieved through cross-pool collaboration for infrastructure investment, something which is already happening. For example, the Northern Pool and the Local Pensions Partnership already have links through the joint infrastructure fund GLIL, which was established by the Greater Manchester Pension Fund (GMPF) and the London Pensions Fund Authority (LPFA) in 2015. Initially launched with £500m, the GLIL fund grew to £1.3bn when Lancashire, Merseyside and West Yorkshire joined in December 2016. GLIL has already deployed approximately £250m of its capital as a co-investor into a number of UK infrastructure projects, and its doors appear to remain open to new LGPS partners.

In addition to the risk and benefit considerations, LGPS making the move into this new asset class will need to establish high quality governance and risk management frameworks in order to safeguard the interests of scheme members. But the risks presented by investment into this asset class are manageable and HSBC believes that the case for infrastructure investment by the pools remains strong.

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4 The Financial Times, ‘UK Infrastructure set for £1.3bn pension fund boost,’ December 5th, 2016. https://www.ft.com/content/991f22f6-c120-11e6-9bca-2b93a6856354
Conclusion

The government believes that the rationale for pooling the LGPS is clear and many agree that the objectives of the initiative are achievable. However, the LGPS are tasked with a monumental programme of work and although significant progress has already been undertaken, the journey has just begun. Despite the significant challenges that lay ahead, this is an exciting time for the industry and the outcome of pooling is likely to be positive for the LGPS.

HSBC is a banking partner to a number of LGPS and it welcomes the opportunity to continue supporting the pools with navigating the challenging road ahead.

Fig 1. How to invest in infrastructure
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