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3rd December, 2015

Mr David Powell
Strategic Director - Resources & Section 151 Officer
Powys Pension Fund
County Hall
Llandrindod Wells
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Dear Mr Powell

Asset pooling and liability management within the LGPS – a route to achieving this

Following the latest announcement from Government on LGPS reform, issued on 25th November, 2015, we wanted to take the opportunity to contact you and colleagues within Powys Pension Fund to introduce the independent Asset Liability Management (ALM) partnership structure that Lancashire County Pension Fund (LCPF) and London Pensions Fund Authority (LPFA) have jointly developed.

In the announcement Government said, *"Authorities are also strongly encouraged to learn from those who have already begun to develop collective investment vehicles, such as the London Boroughs or Lancashire and the London Pensions Fund Authority".*

Although LCPF and LPFA pioneered the ALM partnership structure, our intention from the outset has always been to open it to other like-minded LGPS funds. Government, in seeking these reforms within a tight timescale, has accelerated our plans. We want to share with you what we have done and, if the ALM partnership structure is of interest to you, to have a discussion.

We believe that the ALM partnership structure offers a highly effective route to delivering what Government is asking of the LGPS sector, without pension fund partners' sovereignty being undermined in any way, nor funds losing local accountability.

The background to the ALM partnership structure

The ALM partnership structure allows funds to pool assets to achieve economies of scale and to deploy the tools and knowledge to better manage liabilities on a joint basis, whilst retaining local accountability and maintaining the sovereignty of all pension fund partners. The structure is appropriately regulated by the FCA, providing a high level of assurance for all stakeholders. Further information on the structure and the benefits we identified are included in the attached paper.

When we started on the journey to create the ALM partnership structure some two years ago, we knew at the outset it would be a complicated, complex, time-consuming and expensive entity to develop. This reinforced our determination to create a working and FCA-approved proof of concept, starting with just two funds, before taking it to other partners.

We have now succeeded and created an independent ALM partnership structure, for which all FCA approvals (both for the Authorised Contractual Scheme itself and for the investment subsidiary) should be in place during the first quarter of 2016. It is up and running and will be ready for multiple fund involvement comfortably within Government's timeline, without participating funds having to go through the complex legal, regulatory and operational hoops that LCPF and LPFA have done to get this far.

There are a number of ways for funds to get involved, which will depend on each fund's strategic aims. However, **all** investor funds will benefit equally from the operational benefits to be derived from pooling.

Next steps

The attached provides more information about the ALM partnership structure and what LCPF and LPFA have learned about the potential benefits and savings to be made. There are also some discussion points around the different ways that funds can participate. If this approach is of interest and you would like to find out more about it, please contact either George Graham at LCPF or Susan Martin at LPFA to arrange a discussion. You will find their contact details in the attachment.

Kind regards

[redacted]

Sir Merrick Cockell
Chairman, London Pensions Fund Authority

[redacted]

Cllr Jennifer Mein
Leader, Lancashire County Council

Enc.

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December 2015

ASSET LIABILITY MANAGEMENT PARTNERSHIP

AN INNOVATIVE ROUTE TO POOLED ASSET AND LIABILITY MANAGEMENT

Introduction

The Lancashire County Pension Fund (LCPF) and London Pension Fund Authority (LPFA) have developed a collaboration concept in which multiple LGPS funds can participate in order to deliver on Government's drive for asset pooling by the sector to create significant wealth funds - an Asset Liability Management (ALM) partnership. This is a single organisation, which can provide the full range of pension services functions within a single collaborative agreement and from within local government.

This ALM partnership is the first of its kind within the LGPS. It currently operates with the interim name of the Lancashire and London Pensions Partnership (LLPP).

Although LCPF and LPFA have pioneered the ALM partnership structure, the intention from the outset has always been to open it to other like-minded LGPS funds. Government, in seeking this pooling reform of the LGPS sector within a tight timescale, has accelerated our plans for increased collaboration.

About an ALM partnership

In brief, an ALM partnership allows funds to pool assets to achieve economies of scale and to deploy the tools and knowledge to better manage liabilities on a joint basis. Essentially, an Authorised Contractual Scheme (ACS) creates a vehicle to pool investments. Importantly, the structure ensures individual funds retain their local accountability, keeping control of strategic decisions such as employer contribution rates, strategic asset allocation and setting risk appetite. The sovereignty of all pension fund partners is also maintained. The structure is appropriately regulated by the FCA, providing a high level of assurance for all stakeholders.

Benefits of this approach include:

- improved returns from resulting scale;

- in-house liability management experience which underpins investment strategy;
- reduced pension deficits (potentially by more than would have been achieved by the funds acting independently);
- access to in-house centres of expertise in LGPS management;
- increased access to a wider range of asset classes; and,
- greater access to large scale infrastructure deals.

The vision of ALM partnership collaboration with other funds

With a long term goal of growing the ALM partnership to have c£40bn of assets under management, the next step is for closer collaboration with other funds. Growing by collaborating will enable participating funds to access investment opportunities that are currently unobtainable or complicated to access on a small scale, such as larger scale direct infrastructure investments. The vision is a group of funds collaborating to:

- Achieve enhanced investment, liability and administration outcomes, whilst retaining local accountability and maintaining the sovereignty of all pension fund partners. Participating funds will continue to be responsible for key strategic decisions, such as employer contribution rates, strategic asset allocation and setting risk appetite.
- Create a state-of-the-art pensions services organisation, which through newly-created corporate structures:
    - Manages the liabilities of the administering authorities;
    - Pools the pension fund assets where appropriate;
    - Enables joint management by the partnership of those assets not pooled, and,
    - Combines pension administration services (if required).

Why the ALM route? Our experiences to date

LPFA and LCPF started on the ALM partnership journey some two years ago. Independently, both funds had reached the conclusion that collaboration with other funds could lead to significant benefits for all involved. We came together and decided that the ALM partnership model was the route to delivering what we wanted for our respective funds.

Specifically, we saw a combined structure providing sufficient scale to enable us to attract and retain relevant in-house specialist expertise across the partnership's operations, from investment management and liability modelling, to governance, fiduciary oversight, risk management and administration. This would include absorbing relevant specialists as appropriate from any other incoming funds – the ALM partnership would not seek to lose already prized expertise and experience in a particular investment area or other technical or specialist field. With this essential strength-in-depth and sustainability built into the ALM partnership's DNA, it will also have the necessary skills and information to appoint the best third-party providers for what it seeks to achieve and to work more efficiently and effectively with them, be they fund managers, technology providers or other suppliers.

Since then, we have made significant investment in time, effort and money to develop the ALM partnership model, using our two funds to create a working proof of concept for multiple funds to be involved. The structure has been submitted to the FCA for approval and we expect to receive the necessary approvals in the first quarter of 2016. *Note: we will not seek any contribution from funds that join the ALM partnership towards our joint set-up costs.*

Benefits we have identified arising from the ALM partnership structure include:

Liability Management

Improved understanding of pension fund liabilities and closer engagement with fund employers enables funds to plan their cash flow and determine the returns required from their assets. Real time information on liabilities through sophisticated software and expert in-house analysis reduces triennial valuation costs and time.

Furthermore, strengthening employer covenants reduces liabilities immediately and over time. For example, one of the partners has increased the fund's security by over £360 million through more effective management of employer risk and sector specific covenant checks.

Investment Management

Based on just the experience of the two funds collaborating thus far, we believe that in investment management terms the ALM partnership will:

- Result in fee reductions, offer us access to different types and a greater amount of direct investment, cost reductions in administration and more effective liability management.
- Achieve c£30m savings in investment management fees alone over five years. This will be achieved through larger allocations and by making use of existing specialist in-house asset management skills, specifically in global equities, private equity and infrastructure/property.
- The increased scale will achieve enhanced investment outcomes of around £20m-£30m from their current levels.

Shared Services

Pensions administration services will be delivered through a shared service route. Achievement of scale in this area provides the opportunity to reduce unit costs while retaining high levels of expertise.

The potential is there for the ALM partnership to be the largest LGPS administration grouping (with only two funds involved thus far, it is already the largest fire scheme grouping). This will give the partnership greater influence when negotiating with software providers on key systems, the ability to develop bespoke software, the maintenance of high quality data and the provision of detailed technical support and advice to all stakeholders.

An overview of how funds can get involved in the ALM partnership

LGPS Funds' involvement in the structure could be by one of a number of routes according to individual fund strategic aims:

- **As a full shareholder partner** with equal representation on the Board and a role in the governance of the structure. It is envisaged that a full shareholder position will be reserved for funds of a significant size who want to play a role in the governance of the partnership.
- In the event that a group of smaller funds seek participation at Board level, it may also be possible to reserve a portion of the shareholding for such a group who would elect one voting member to the Board.
- As **an investor in the Authorised Contractual Scheme (ACS) only**. Counsel's opinion has been sought and the advice is that this route is possible without the need for the investing fund to run a procurement process. An investor group could be established to represent funds participating this way.
- As **an administration shared service partner (if required by funds).** In effect, this is a Local Government Shared Services option, which would be initiated under Lancashire County Council's shared services powers. No procurement process would be required.
- Potentially, as a **shareholder partner in the administration subsidiary**. Funds that wanted to play a part in the governance of the administration subsidiary could potentially be offered a shareholding. This participation route also avoids the need for a procurement process.

Ensuring all investors benefit equally

It is a guiding principal of the ALM partnership is that all investors should benefit equally.

The operational benefits associated with the scale that pooling creates will be equally applicable to all investors. It will not be the case that shareholders will derive greater level of operational benefits than the investors.

Any surpluses will be retained to improve the services to all partners and to reduce the cost to partners of the services, through retrospective rebates, and prospective price reductions.

Next steps

We are keen to talk to funds who would like to explore the possibility of collaborating in this ALM partnership structure. Please email or telephone George Graham or Susan Martin to arrange a one-to-one meeting at your offices.

Contact details:

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