

# Proposals for LGPS Fund Reporting in a 'Pooled World'

May 2018

## Objectives

1. This paper sets out proposals for revised reporting for LGPS pension funds to meet a number of objectives as set out below:
  - to meet government requirements for
    - measuring progress by funds in transitioning assets into pools;
    - transparent reporting of costs and performance by the LGPS funds and pools
    - demonstrating that active management of investments provides added value to the scheme
    - measuring increased capacity for cost-effective investment in infrastructure
  - to further enhance reporting of costs reflecting
    - the introduction of the Local Government Pension Scheme Advisory Board (SAB) Code of Transparency for asset managers
    - initiatives underway by the Financial Conduct Authority (FCA) and Department for Work and Pensions (DWP) which aim to create more transparent and granular reporting standards for both providers and trustees
  - to develop the current asset allocation reporting in order to avoid the majority of assets being consolidated into the Pooled Investment Vehicles (PIV) line within the pension fund accounts.
2. The purpose of the paper is to provide guidance on how costs currently reported by a number of separate entities to meet financial reporting requirements can be identified and presented in a way that more transparently explains both the method of management and full cost of investment transactions over time.
3. The intention is that much of this information will be reported in the Investment Report section of the pension fund annual report, because this will make the link between investment cost, performance and risk. The information can then be used by the SAB to consolidate into the national annual report to permit reporting progress on asset pooling at a national level.
4. Alternative reporting has been considered but discounted for the following reasons:
  - inclusion within the pension fund accounts, because much of the information to be reported falls outside the scope of accounting standards

- additional information in the SF3 return, because the information in the SF3 is not subject to external audit scrutiny
- a separate information return, because this would provide a fourth reporting route (in addition to the pension fund accounts, pension fund annual report and SF3), which was seen as an unnecessary additional burden.

## Status

5. This paper has been issued by CIPFA as good practice which is to be incorporated into 2018/19 Annual Report guidance for local government pension funds. It would be helpful however if funds could also apply the guidance when preparing their 2017/18 annual reports and feedback any practical issues encountered. Proposals can then be refined as necessary before the Annual Report guidance is finalised.

## Principles

6. These proposals are based on the following principles:
  - fully disclose all investment costs impacting on the return available to the fund
  - analyse costs to an appropriate level of granularity ensuring an effective balance between regulatory requirements, usefulness to readers, resource demands on fund officers and commercial sensitivity
  - report costs and performance in a consistent manner which meets the government's requirements and enables the SAB to consolidate reporting of those items to the pool and scheme level
  - effectively separate the set-up and ongoing costs of asset pools at fund level.
7. For the purpose of defining those assets which are classed as being within an asset pool, 'pooled assets' are those for which implementation of the investment strategy – ie the selection, appointment, dismissal and variation of terms for the investment managers (including internal managers) – has been contractually transferred to a third party out with the individual pension fund's control. Each pool is responsible for establishing and managing its own governance arrangements. 'Assets' could comprise any type of cash-based or equity instruments, or investments in infrastructure, residential and commercial property.
8. Accounting for pooled assets within each pension fund's financial statements must follow the general principles of 'principal and agent' in accordance with the Code of Practice on Local Authority Accounting in the United Kingdom 2018/19 which in turn is based on IAS 18 Revenue, IPSAS 9 Revenue from Exchange Transactions and IPSAS 23 Revenue from Non-Exchange Transactions (Taxes and Transfers).
9. How these requirements are then applied in practice will depend on what operating model each pool chooses to adopt. For example, the pool may set up a limited company to run jointly owned collective investment vehicles and other long and short-term investment arrangements (scenario one). Alternatively, the pool company could be set up to select managers to run segregated mandates owned by each participating LGPS (scenario two). Under scenario one, the pool company would be acting as a principal, because there would be no segregation of assets to individual pension funds. In scenario two, the pool company would be acting as an

agent on behalf of the LGPS when placing and managing investments, but as a principal on its own account when employing staff or incurring running costs.

## Proposals

### Measuring transition of assets to asset pools

10. There are a number of options within the recommended format of LGPS year-end accounts for reporting progress in transitioning assets to asset pools:
  - separate reporting on the face of the net assets statement within the pension fund accounts
  - separate reporting of assets managed within the asset pool and those without via the disclosure of fund assets by fund manager (Code para 6.5.5.1 (h) or Note 14C in the example pension fund accounts)
  - separate reporting of assets in the analysis of investments assets (Code para 6.5.5.1(i) of Note 14B in the example pension fund accounts).
11. The preferred option is separate reporting within the disclosure of fund assets by fund manager, because the allocation of assets to asset pools is a form of fund management which would not require amendment to the Code. Separate reporting on the face of the net assets statement would be a deviation from Code reporting requirements, while separate reporting in the analysis of assets is too granular a level of reporting. The example disclosure below has been adopted by a number of authorities transferring investments to the London CIV:

### Example disclosure

31 March 2017			31 March 2018	
Market Value	%	Fund Manager	Market Value	%
£'000			£'000	
<b>Investments managed by XYZ asset pool:</b>				
345,315	8.3%	Ellebeau inhouse investment team	391,603	8.9%
4,511	0.1%	ABC Currency Management	1,088	0.0%
		National & General Investment Management	589,938	13.4%
		Alternative assets	941,774	21.4%
<b>349,826</b>	<b>8.4%</b>		<b>1,924,403</b>	<b>43.7%</b>
<b>Investments managed outside of XYZ asset pool:</b>				
553,783	13.3%	National & General Investment Management		
755,917	18.1%	Alternative assets		
245,867	5.9%	XYZ Credit Management Ltd	248,905	5.7%
804,457	19.3%	Offside Investment Management Ltd	872,569	19.8%
551,486	13.2%	SFM International (UK) Ltd	544,237	12.4%
481,161	11.5%	White Stone Investment Managers	389,104	8.8%
434,137	10.4%	Faraday Investment Managers	425,655	9.7%
<b>3,826,808</b>	<b>91.6%</b>		<b>2,480,470</b>	<b>56.3%</b>
<b>4,176,634</b>	<b>100.0%</b>		<b>4,404,873</b>	<b>100.0%</b>

During 2017/18, the fund transitioned assets with National and General Investment Management and Alternative to XYZ asset pool. Assets managed by Offside Investment Management Ltd and SFM Internal (UK) Ltd were transitioned post year-end in May 2018.

## Cost reporting

12. CIPFA has made great progress in improving the reporting of management costs by pension funds. However, the development of asset pools within the LGPS (which is unique to the pensions sector) means that there are likely to be a range of additional one-off and ongoing costs, which readers and users of the annual reports will be interested in.
13. Costs fall into three broad groups:
  - setting up the asset pool (ie costs incurred prior to the pool receiving FCA approval and starting to trade)
  - commissions, fees and taxes incurred as a result of transitioning assets from existing fund managers to the asset pool
  - ongoing investment management costs.
14. It is not envisaged that these costs will be separately reported in the pension fund accounts as they are unlikely to be material. However, they are of interest to stakeholders, including the government and the SAB. Therefore, the recommendation is that this information will be reported in the pension fund annual report, but it will need to be consistent with costs reported in the pension fund accounts. To this end direct costs incurred by the pension fund should reconcile to management costs within the pension fund accounts, whilst indirect costs will be costs which would not be reported in the pension fund accounts, because the pension fund has no direct liability for these costs.
15. For example, costs incurred and services provided by fund managers and constituent authorities which have been recharged to the asset pool on a cost or cost-plus basis should be recorded as direct costs. Where these are provided free of charge, an estimate of their value should be made and then included in indirect costs for comparative purposes.
16. The costs of setting up asset pools will include the costs of setting up the asset pool itself, whether this is setting up a company or buying in a third party provider, and then the costs of transitioning assets into the pool. While the costs of setting up the pool are likely to run over a two to four year period, the costs of transitioning assets could take up to ten years. Whilst an estimate of the full costs of set-up and transition will be made at the outset, actual costs will only be recorded for accounting purposes in the financial year in which they incurred.
17. To improve transparency for stakeholders, cost disclosures in annual reports will therefore need to include cumulative totals as shown below. For pools operating outside London, costs should be captured as a minimum from March 2015 (business case submission date).

## Example disclosure of asset pool set-up and transition costs

	Direct	Indirect	Total	Cumulative
	£000s	£000s	£000s	£000s
<b>Set up costs:</b>				
Recruitment				
Legal				
Procurement				
Other support costs eg IT, accommodation				
Share purchase/subscription costs*				
Other working capital provided eg loans				
Staff costs**				
Other costs				
<b>TOTAL SET UP COSTS</b>				
<b>Transition costs:</b>				
Transition fees				
Taxation (seeding relief)				
Other transition costs				
<b>TOTAL TRANSITION COSTS</b>				

\* Include the cost of purchasing shares in the asset pool vehicle where this is a company limited by share capital. Even though these costs will have been treated as an investment in the pension fund or single entity authority accounts, these are a directly attributable cost of setting up the asset pool and so should be included in the table above. Similarly until the asset pools are fully operational it is likely that asset pools may need to charge a subscription fee to pool members, which should be included in the set-up costs.

\*\* Include costs of seconded and directly employed staff involved in establishing the asset pool and working for the pool company prior to commencement of trading. For directly employed staff, costs should also include employers' pension contributions and past service pension costs if these have been transferred from their previous employment.

18. This information should be presented alongside:

- in-year and cumulative savings achieved to date
- total expected costs and savings as set out in pool Business Case submissions presented to MHCLG.

## Reporting ongoing investment management costs

19. The introduction of the Packaged Retail and Insurance-based Investment Products (PRIIPS) Regulation requires fund managers to report their research costs separately and to either bill this to their clients or to absorb such costs themselves. Where fund managers adopt the former approach, this will require the investment management agreement (IMA) to be amended to permit the fund manager to bill the research costs directly to the client pension fund.
20. In addition, users of the annual reports are concerned about the extent to which fees are affected by buying and selling which reflects individual fund manager investment style. A turnover % or similar information should be provided which allows the user to see the difference in styles of managers where this is significant.
21. To ensure consistency with information reported in the pension fund accounts, cost will need to distinguish between direct costs which should reconcile to the

management costs disclosure in the pension fund accounts and indirect costs. One option would be to show costs at the asset category level however this could inadvertently disclose commercially sensitive cost data if there is only one manager in that space.

22. A suggested analysis is set out below. This has been based on guidance contained in the CIPFA publication *Accounting for Local Government Pension Scheme Management Expenses* (2016 edition), which most LGPS funds already follow when preparing the year-end statement of accounts. The guidance explains which costs should be allocated to the various categories of expenditure and setting out a consistent approach to accounting for recharges, shared costs etc.

### Example disclosure – ongoing investment costs

	Asset Pool				Non-Asset Pool				Fund Total	
	Direct	Indirect	Total		Direct	Indirect	Total		£000s	bps
	£000s	£000s	£000s	bps	£000s	£000s	£000s	bps		
<b>Management fees</b>										
ad valorem										
performance										
research										
PRIIPS compliance										
<b>Asset pool shared costs</b>										
<b>Transaction costs</b>										
commissions										
acquisition/ issue costs										
disposal costs										
registration/filing fees										
taxes and stamp duty										
<b>Custody</b>										
<b>Other</b>										
<b>Total £000</b>										

23. There may be a need to analyse or explain shared costs (sub fund operational costs recharged to individual investors) depending on whether these are reported at pool or transaction level by managers or operators. In determining which direct costs should be reported, practitioners should have regard to the principal and agent accounting principles outlined above.
24. It should also be noted that the following initiatives are in progress:
- The SAB has issued cost reporting templates to fund managers in support of the Code of Transparency launched in February 2018.
  - The Financial Conduct Authority's (FCA) Institutional Disclosure Working Group (IDWG) is developing a template for disclosing investment fees and management cost information in a consistent and transparent way that enables investors to assess performance and make more effective decisions.
25. It is envisaged that as the format, completion, and publication of these templates becomes a more established process, the table above will be reviewed and amended as necessary to ensure consistent reporting of all available information.

## Asset allocation and performance

26. In order to report performance and the extent to which active management adds value to pension funds, it is proposed that gross and net return are reported by asset class and against both:
- performance of the relevant passive index and
  - local performance benchmarks as set out in the pension fund's investment strategy.
27. Performance should be measured over one, three and five year timeframes and annual reports will need to explain exactly which performance benchmark is being applied (the MSCI World Index or similar should be used).
28. In order to reflect risk, the benchmark and performance reported should be 'risk adjusted' as well as providing absolute amounts. Risk-adjusted reporting, generally expressed as a number or index rating, measures how much risk is involved in producing that return. Common risk measurements include alpha, beta, R-squared, standard deviation and the Sharpe ratio but bearing in mind that different risk measurements give very different analytical results, reports should be clear about which measurement is being used and, so far as possible, try to ensure consistent reporting between fund managers at individual pension fund level.
29. To report gross and net return consistently, this paper takes the approach that net return is the return net of all direct and indirect costs (ie net of anything which reduces return). Gross return excludes all costs. Cost reporting corresponds with management costs reported in the accounts as set out below:

<b>Net performance</b>	
ADD direct costs	= management costs reported in the fund account
ADD indirect costs	= added to direct costs is management costs reported in the annual report
<b>= Gross performance</b>	

30. It should be noted, however, that the proposed IDWG template is also developing a framework for more consistent reporting of gross and net investment performance. When this template has been finalised and published, the table shown above will be revised as necessary to ensure consistency.
31. Given the increasing use of pooled investment vehicles to spread risk and address particular strategic investment objectives by pension funds, it is proposed that the current pooled investment asset category within the Code is sub-analysed. This will help measure the extent to which pension funds approach a diversified asset allocation strategy.
32. The suggested sub-analysis of pooled investment vehicles is shown below.

**Pooled Investment Vehicles:**

Active listed equity	Unlisted equity
Active fixed income	Infrastructure
Passive listed equity	Cash
Passive listed income	Multi-Asset Funds/ Diversified Growth Funds
Private debt	Other
Property	

33. LGPS funds often choose to specifically allocate to Multi-Asset Funds (MAFs) so there is potentially a case to show these as an asset category rather than seeking to split the investment into its underlying asset types.
34. There are a number of different definitions of infrastructure. However to ensure consistency between funds and with government objectives, it is proposed to use the definition drawn up by the cross-pool working group, set out below:

**Infrastructure assets** are the facilities and structures needed for the functioning of communities and to support economic development. When considered as an investment asset class, infrastructure investments are normally expected to have most of the following characteristics:

- substantially backed by durable physical assets
- long life and low risk of obsolescence
- identifiable and reliable cash flow, preferably either explicitly or implicitly inflation-linked
- revenues largely isolated from the business cycle and competition, for example, through long term contracts, regulated monopolies or high barriers to entry
- returns to show limited correlation to other asset classes.

Key sectors for infrastructure include transportation networks, power generation, energy distribution and storage, water supply and distribution, communications networks, health and education facilities, social accommodation and private sector housing.

Conventional commercial property is not normally included, but where it forms part of a broader infrastructure asset, helps urban regeneration or serves societal needs it may be. Infrastructure service companies would not normally be included.

35. For each of the categories above it is proposed that both an opening and closing allocation is shown (in both £ and % terms) as well as gross and net % performance measured against both the relevant passive index (for listed assets) and any locally determined performance targets. This could be a targeted internal rate of return or measurement against an external benchmark such as the Investment Property Databank (IPD) index, providing that in each case what is being measured and reported should be made clear.
36. It is proposed that this information is provided at asset class level, as shown below. Reports may, in addition, wish to include a geographical analysis of investment holdings and returns where this will aid users' understanding of performance and risk.



37. The summary analysis below is based on the standard asset analysis required under the Code but with the following additions:
- bonds, equities and pooled investment vehicles to be distinguished between actively and passive managed
  - the separate disclosure of infrastructure from pooled investment vehicles (where such investments fit within the pension fund accounts under the Code) in order to measure the extent to which pension funds are moving toward investment in this sector

## Example disclosure – asset allocation and performance

\*use weighted passive index for listed assets only

Asset category	Opening value		Closing value		Performance		Passive Index*	Local target
	£000	%	£000	%	Gross %	Net %		
<b>Asset Pool managed investments</b>								
Bonds - active								
Bonds - passive								
Equities - active								
Equities - passive								
Pooled Investment vehicles - active								
Pooled Investment vehicles - passive								
Derivatives							N/A	
Hedge funds							N/A	
Property - directly held							N/A	
Infrastructure							N/A	
Insurance policies							N/A	
Loans							N/A	
Cash							N/A	
<b>Total</b>								
<b>Non-Asset Pool managed investments</b>								
Bonds - active								
Bonds - passive								
Equities - active								
Equities - passive								
Pooled Investment vehicles - active								
Pooled Investment vehicles - passive								
Derivatives							N/A	
Hedge funds							N/A	
Property - directly held							N/A	
Infrastructure							N/A	
Insurance policies							N/A	
Loans							N/A	
Cash							N/A	
<b>Total</b>								

38. A more detailed analysis of asset allocation and performance should also be provided for pooled investment vehicles as shown below. Performance data in both tables should be reported on a one, three and five year basis.
39. When completing this analysis practitioners should bear in mind that categorisation depends upon the primary purpose of the investment. Care should also be taken when considering insurance policies. Pension life funds, often referred to as insurance, are primarily a pooled investment vehicle. Other policies, taken out as protection against a specific risk such as pensioner longevity, should be classed as insurance policies.

## Example disclosure – pooled investment vehicles

\*use weighted passive index for listed assets only

Asset category	Opening value		Closing value		Performance		Passive Index*	Local Target
	£000s	%	£000s	%	Gross %	Net %		
<b>Asset Pool managed investments</b>								
Pooled investment vehicles:								
Active listed equity								
Active fixed income								
Passive listed equity								
Passive listed income								
Private debt								
Property								
Unlisted equity								
Infrastructure								
Cash								
Multi-Asset Funds/ Diversified Growth Funds								
Other								
<b>Total</b>								
<b>Non-Asset Pool managed investments</b>								
Pooled investment vehicles:								
Active listed equity								
Active fixed income								
Passive listed equity								
Passive listed income								
Private debt								
Property								
Unlisted equity								
Infrastructure								
Cash								
Multi-Asset Funds/ Diversified Growth Funds								
Other								

## Baseline performance reporting

40. To measure the extent to which pension funds have saved fees as a result of pooling, it is necessary to calculate price and quantity variances. The price variance measures the extent to which fee rates have generated savings. The quantity variance measures the extent to which fees have changed in line with the value of the assets on which they are based.

41. The price variance is calculated as:

- the fund value currently x (old fee rate – new fee rate).

Note: Both old and new *ad valorem* fee rates should include a realistic estimate of any performance-related fees likely to be payable, together with expected transaction costs.

42. The quantity variance is calculated as:

- old fee rate x (old fund value – current fund value).

43. A worked example is set out below. In this example fees increased by a total of £123,000. Had the fund continued under the previous fee arrangement, fees would have increased by £242,000 (the quantity variance). The saving to fund from the new fee rates is therefore £119,000 (the price variance).

44. Where transitioning involves a change to the existing mandate, calculations may need to be carried out in terms of price, quantity and asset allocation variance to distinguish between:

- variances attributable to the change in mandate and
- variances attributable to the move into the asset pool.

45. The cost variance analysis described above should be accompanied by a qualitative explanation (changes in price, volume, asset mix, etc) and presented in the context of changes in performance and risk. CIPFA's 2018/19 Annual Report guidance will provide further examples.

46. More detailed information on the direct and indirect costs of investment activity should start to become available in 2018/19 as a result of the LGPS Code of Transparency and the work of the IDWG. This data will be used to develop:

- a common terminology for, and more consistent understanding about, the various components of investment costs and
- more sophisticated models for analysing relative performance and the impact of moving from an individual authority to a pooled model.

## Variance analysis

<b>Calculating price and quantity variances for an asset portfolio transferred to an asset pool at 1/10/16, as at 31/3/18</b>			
Value of assets at 1/10/16	£112m		
ad valorem fee rate	55bp per £1m		
Value of assets at 31/3/18	£156m		
ad valorem fee rate	50bp per £1m on first £100m		
	45bp per £1m on next £30m		
Fund	40bp per £1m on next £30m		
<b>Price variance</b>			
Current fund value at old rate	£156m x £0.0055 =		£858,000
Current value at new fee rate	£100m x £0.0050	£500,000	
	£30m x £0.0045 =	£135,000	
	£26m x £0.0040 =	£104,000	
			£739,000
<b>PRICE VARIANCE</b>			<b>£119,000</b>
<b>Quantity variance</b>			
Old rate x (old fund value - new fund value) =	£0.0055 x (£112m - £156m)		
<b>QUANTITY VARIANCE</b>			<b>(£242,000)</b>
<b>Total variance</b>			
<b>TOTAL VARIANCE</b>	Old fees - new fees =	£616,000 - £739,000 =	<b>(£123,000)</b>

## National reporting

47. Following the submission of annual reports to the SAB a process will be undertaken to consolidate the allocation, performance and cost data from the LGPS funds into the eight pools and the LGPS scheme as a whole. The SAB will publish this data as part of the Scheme Annual Report.