Appendix B

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The Northern Pool
Advising the Northern Pool on Operational Structures

28 June 2016

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1. Executive summary

This report has been prepared for the Northern Pool, made up of the Greater Manchester Pension Fund ('GMPF'), the West Yorkshire Pension Fund ('WYPF') and the Merseyside Pension Fund ('MPF'). This report is prepared to assist the Pool in its consideration of certain alternative operating models that the Northern Pool could use as part of their response to DCLG's Local Government Pension Scheme Pooling initiative.

Our analysis covers three possible operating models for the Northern Pool, as we have previously explored at a higher level:

1. **Own ACS operator:**
2. **AIFM without ACS**
3. **Joint committee**

We have split our analysis up into three separate phases, as set out in our proposal document dated 23rd May 2016:

Phase 1 – Operational cost differentials
Phase 2 – Asset transition and tax
Phase 3 – Operational & Asset Holding Structures

In summary, the estimated cost differentials between the three structures on a set up and ongoing basis are set out in the tables below.

Structure	**1. ACS Operator with ACS Fund**	**2. AIFM with no ACS**	**3. Joint Committee**
Set up costs	£6.0m - £10.2m	£1.8m	£1.2m
Incremental ongoing costs	£2.05m p.a.	£0.7m p.a.	£0.2m p.a.

Key – Red = highest cost, Green = lowest cost

Time	**Outset**	**After 5 years**	**After 10 years**
Cumulative cost difference between 1. and 2.*	£4.2m - £8.4m	£10.95m - £15.15m	£17.7m - £21.9m

*Note – the cost difference assumes that the ACS Fund is able to benefit from c£1.5m pa in withholding tax efficiency on French dividends. If this is not the case in practice, the cost differential could be £15m wider after 10 years i.e £32.7m - £36.9m.

It should be noted that the above sets out the differentials between the structures, not a bottom up assessment of costs. We recommend the detailed financial model to support the business case and regulatory application is prepared as part of the next phase

Set up costs

Set up cost for the ACS Operator with ACS Fund are expected to be significantly higher than for the other structural options, primarily due to:

1. A greater level of legal, financial, tax and regulatory advice required in order to set up the vehicle
2. Significant transactional taxes due to a change in legal ownership

This means that there is a significant investment required to set up an ACS, when compared with the other options. The AIFM without ACS would be cheaper to set up and would also be a regulated entity. It is assumed that this entity and the AIFM with ACS would deal with alternative assets in the same way outside of an ACS structure and as such there should be no cost differentials there.

Ongoing costs

The ACS is also expected to be the most expensive structure to run, as it will require more regulated staff, there is a higher cost of compliance and the custodian would have to provide additional services, such as depositary and fund administration, which have significant annual costs associated with them.

There is therefore a c£1.35m difference in annual costs between the ACS and the AIFM without ACS, meaning that the cumulative cost differential between the 2 operational structures will widen over time. This differential could increase further if the ACS is not able to take advantage of withholding tax efficiency on French dividends at any point in the future.

Operational structures

Although it is the cheapest structure to establish and run, the Joint Committee structure is the only one out of the three that is non-regulated, and DCLG has already discouraged such an approach, due to the perceived lack of clarity over governance and oversight.

The ACS operator with ACS Fund and the AIFM without ACS are both regulated entities, with lower cost under the AIFM without ACS structure due to operational and compliance costs of the ACS fund itself.

The ACS operator will take longer to establish due to a more robust authorisation processes plus higher advisor requirements, especially around the tax treatment of transferring assets, transparency of the fund and the legal structure.

It is expected that internal staff from the Funds would transfer into either the ACS operator or into the AIFM. Regulatory authorisation will be required of key individuals in order to perform their roles. To the extent that existing key staff of the funds are transferred to the pool, this could result in skill shortages in the Funds and we recommend that role mapping is performed and benchmarked at the Asset Manager, Fund and Administering Authority level as soon as possible in the next phase once a high level structure is selected.

Other considerations and comments

As we have discussed with the Pool, due to the scale of the current assets within the 3 LGPS Funds, it is not anticipated that one structure would give additional savings in asset management fees over another one. Each of the structures is expected to benefit from a reduction in custodian fees, as was confirmed in our recent meeting with BNP Paribas.

We have assumed that, regardless of the structure, each Fund will retain current investment managers and mandates around listed equities and bonds in the short term. In practise, if any changes are made to consolidate mandates with a particular manager, then we expect that there will be a minimum 5bps charge to transition the assets that are moved (maybe 30/40% of a portfolio). However those transition fees would be similar whether the transition takes place inside or outside an ACS fund.

In regards to the regulated structures, it should be noted that the second structure, an AIFM without the ACS would provide the most flexibility through the early years of the pool, being able to set up and operate different funds for the pool for different investments and to carry out segregated investment management or asset manager selection where more appropriate. The AIFM (with MiFID type permissions as appropriate) would need to have a fund it sets up and operates and this could for example be a Real Estate or Private Equity Fund. The AIFM could also establish an ACS fund in time should the financial benefits seem worthwhile once the pool evolves. It will be important for the Pool to ensure that the segregated portfolio management activities of the Pool do not 'taint' the AIFM status of the manager and we would recommend further guidance is sought on this point in the next phase.

Due to the unique nature of the 3 Funds in the Northern Pool, in particular the scale of the Funds, low level of existing mandates and existing low investment manager fees already in place, alongside relatively high level of internal management, it is expected that the benefits of pooling will be realised regardless of whether appropriate investments are held via an ACS or outside of an ACS. In fact the ACS structure may well result in a less efficient solution for the pool for relevant asset classes. In either of the regulated structures the benefits of pooling for alternative assets could be achieved to the same degree as these would be invested in relevant alternative funds that could be established under either structure.

2. Introduction and background

Introduction

This report has been prepared for the Northern Pool, made up of the Greater Manchester Pension Fund ('GMPF'), the West Yorkshire Pension Fund ('WYPF') and the Merseyside Pension Fund ('MPF'). This report is prepared to assist the Pool in its consideration of certain alternative operating models that the Northern Pool could use as part of their response to DCLG's Local Government Pension Scheme Pooling initiative.

Our analysis compares both the set up and ongoing costs arising from each structure and considers the costs of asset transfers into an ACS fund. This analysis provides a useful comparison from a costs perspective of the three structural options being considered. The report also compares and contrasts the different operating and asset holding structures and notes the tax considerations that the Pool will need to bear in mind.

The report is to support the Northern Pool's final submission to the Government on 15 July regarding their investment pooling intentions and for the meeting with Treasury on 16 June.

More information on our scope is contained below.

Our scope

In our previous report dated February 2016 and meetings, we considered three different operating models that the Northern Pool could use to pool assets. These were:

1. ***Own ACS operator.*** *The Northern Pool Funds would manage all assets via an FCA regulated Asset Management Company. The Company would also establish an ACS fund for holding appropriate assets (notably listed equities, bonds and possibly real estate). The asset management company would be overseen by a Joint Committee arrangement.*
2. ***Joint Committee with Asset Manager.*** *The Northern Pool Funds would manage all assets via an FCA regulated Asset Manager Company. The Listed bonds, equities and real estate would not be held in an ACS fund established by the pool but held in segregated mandates. The asset management company would be overseen by a Joint Committee arrangement.*
3. ***Joint Committee.*** *An Oversight Group is set up by the participating funds to manage assets collectively but no FCA regulated business is established.*

It is important to set some context for the various structures above, in particular the ACS operator. The difference between structures 1 and 2 essentially comes down to whether the funds would hold certain assets in a fund structure (ACS) created and managed by the asset management company, or not. It is not currently envisaged by any LGPS pool that all assets would be held in a single ACS fund as that vehicle is not suitable for all assets. We have considered the advantages, disadvantages and costs of an ACS for listed equities, bonds and real estate for the Northern Pool. In each of structures 1 and 2 the asset management company may decide to hold other assets (private equity, infrastructure) via alternative structures which would be considered on a case by case basis.

As part of our previous work, we identified with the Northern Pool that the ACS option was likely to be relatively costly as an option. However, this is one of the key vehicles created by the UK authorities for asset pooling and we are aware that it is being considered by a number of other pools. It should be noted that any structural decision will be impacted by the facts of the case, for example the current investor profiles of the Funds in the Northern Pool. It is clear that there is not one solution for all answers for pooling in the LGPS.

We have split our work into three phases – 1) operating costs, 2) asset transition and taxes, 3) advantages and disadvantages for each structure. Given the views articulated by Treasury regarding the need for a separate, FCA regulated operating company, our focus has mainly been on structures 1 and 2. These two structures will both involve a regulated asset manager which does appear to be a base requirement. Treasury have been less prescriptive on asset holding structure such as the ACS and do appear willing to consider alternative structures put forward by the Pools.

We have expanded upon the initial work that we have undertaken for you and built upon this analysis to consider a wider range of operating costs, asset classes and transactional taxes, based on the actual holdings of all three Funds in the Northern Pool.

A summary of the first two structures is set out in this section. We have not included a structural summary of the Joint Committee, due to the lack of an FCA regulated vehicle and the importance that DCLG is placing on this.