



South Tyneside Council

Local Pension Board

Date: 20th December 2017

Cost Transparency

Report of the Corporate Director Business and Commercial Development

Purpose of Report

1. This report describes the regulatory and best practice environment for cost transparency in relation to investments made by LGPS Funds, and the approach taken by the Tyne & Wear Pension Fund.
2. The Local Pension Board is asked to note the report.

Regulatory and Best Practice Background

3. There are no regulatory requirements in relation to transparency of investment costs. Administering authorities are, however, encouraged to follow CIPFA's Code of Practice on Local Authority Accounting in the United Kingdom (the Code).
4. The Code requires summary disclosure of investment costs only, but recommends that administering authorities have regard to CIPFA guidance. The guidance aims to go further in improving transparency, consistency and comparability of information.
5. The guidance was first issued in 2014 and has been updated several times since then. Key points are:
 - there should be disclosure of all matters material to an understanding of the financial position and financial performance of the entity
 - as a minimum, costs should be broken down between investment, administration and governance costs
 - investment costs should be further broken down into transaction costs, fund management fees, performance fees and custody fees
6. One of the more significant issues where there has been a lack of transparency is on accounting for investment costs in pooled funds and private markets funds. They have traditionally not been reported by administering authorities as they are not directly incurred.
7. The guidance requires that all costs incurred by the entity the administration authority contracts with are "grossed up" and are reported in the same way as are costs in relation to segregated investments.
8. Costs incurred by underlying entities that an administering authority does not contract directly with, such as investment funds within a fund of funds structure, need not be disclosed in the financial accounts. Instead, they should be reported in the Fund's Annual Report.
9. Following an assessment by CIPFA of compliance with the Code and associated guidance it was determined that approximately one quarter of administering authorities had adopted it. One quarter had followed the guidance in part, and half had not followed the guidance at all.
10. Further consideration of tackling this issue coincided with the creation and evolution of the Scheme Advisory Board (SAB), whose role is to encourage best practice, increase transparency and coordinate issues in relation to the LGPS.

11. The SAB recently completed a piece of work aimed at tackling this very issue. Working with the LGA and the Investment Association, the SAB published the Code of Transparency in August 2017. The SAB's website says:

“The move toward investment fee transparency and consistency is seen by the Board as an important factor in the LGPS being perceived as a value led and innovative scheme. Transparency is also a target for the revised CIPFA accounting standard issued for inclusion in the statutory annual report and accounts and included in the government's criteria for pooling investments.

To assist LGPS funds in obtaining the data they require in order to report costs on a transparent basis the Board has developed a voluntary Code of Transparency for LGPS asset managers.”

12. Signatories to the Code of Transparency commit to completion and submission of a cost template to their LGPS clients, identifying different categories of fees, costs and other charges. The template is suitable for public markets investments, with a separate template suitable for private market investments to be published in due course.
13. The templates will be further developed to reflect the experience of how they are used, and any changes to the disclosure requirements of the investment management industry.
14. Further information on the Code of Transparency is available at <http://www.lgpsboard.org/index.php/structure-reform/cost-transparency>.

Background of Cost Transparency in the TWPF

15. Each year, the Pensions Committee approves the annual budget for the forthcoming financial year. At each of these times, the preceding year is reviewed and an explanation of the material variances provided.
16. Investment management fees on public market investments have always been included in this process throughout the life of the Fund. Fees on private market investments have been included since they were first made, in the early 2000's.
17. Underlying fees on fund of fund structures were first incorporated into the budget setting process in 2015, for inclusion in the annual budget for 2016/17.
18. Budgeting for private markets investments has proven to be very challenging. Their fee structures typically have a significant performance element, increasing their variability, particularly when the economic environment changes significantly.
19. The disclosure of this information in budgets is over and above the requirements of the CIPFA Code and guidance. All that is required is

disclosure in the report and accounts. Nevertheless, this is considered to be good practice in order to inform the Committee and the Local Board of the level of costs being incurred.

20. The Fund started receiving information on transaction costs from the investment managers in 2005 following the introduction of the Pension Fund Disclosure Code. Since then, the Pensions Committee has received annual reports on transaction cost monitoring. These reports examine the commission and research costs charged to the Fund and provide manager comparisons, year on year comparisons, and comparisons in relation to industry standards.
21. The Fund has at all times complied with accounting standards in relation to the financial accounts. Until the publication of the CIPFA Code, a note identifying the value of transaction costs was required, rather than these costs be incorporated into the monetary values of the accounts.
22. The Fund was one of the early adopters of the CIPFA Code and guidance. The 2015/16 accounts fully disclose the investment costs for all public and private markets managers, for both the 2015/16 and the comparative 2014/15 years. In addition, a note on underlying costs incurred in fund of fund structures has been included in Annual Reports since 2015/16.
23. The Fund's approach in this area has been commended by the external auditors, Ernst and Young and before that PriceWaterhouseCoopers.

Code of Transparency

24. The current Code of Transparency only applies to public markets investments. All of the Fund's public markets investment managers have become signatories to it, and have therefore committed to provide annual cost information on this basis.
25. The Code of Transparency asks for detailed information. The table below compares this to the information already collected, monitored and reported by the Fund.

Code of Transparency	TWPF
Management fees	Included in the annual budget and reported in the accounts
Performance fees	Included in the annual budget and reported in the accounts
Broker commission	Included in the annual transaction cost monitoring report and reported in the accounts

Research	Included in the annual transaction cost monitoring report and reported in the accounts
Transaction taxes	Reported in the accounts
Implicit costs	No action

26. Broker commission and research costs are reported on, but are not included in the budget process. These costs are managed and paid by the investment managers and the Fund is not directly involved.
27. MIFID II (Markets in Financial Instruments Directive II) will be in effect from 3 January 2018. One requirement will be for research to be unbundled from broker commission costs and separately charged. Four of the Fund's six public markets managers have decided not to pass on research costs from this date.
28. Transaction taxes are a cost beyond the control of the Fund, and are a function of the markets in which each manager operates and the turnover rate of the portfolio. They are therefore reported in the accounts as a cost incurred but are not included in the budget process.
29. Implicit costs represent the loss of value implied by the difference between the actual transaction price and the mid-price of the asset. This is considered to be a cost of doing business but no amounts are actually paid, so these costs are not included in the budget process and the CIPFA Code does not make any recommendations for disclosure in the accounts.
30. The template also records cost sharing arrangements in relation to stock lending and custody and other charges on investments. These are included in the Fund's budget process and are reported in the accounts.
31. So far, two of the Fund's investment managers have completed the template, providing information for 2016/17. At this early stage in the roll-out of the Code of Transparency there are no other explicit costs being declared that are not already identified and reported on, but the position will be closely monitored.
32. Once the Code and templates have been expanded to include private market investments, the Fund will again review its practices against these requirements to ensure that it is complying with best practice. In the absence of this, it should be noted that the Fund already uses its own templates to record and report on the costs and expenses of its private market investments.

Conclusion

33. Fees and costs have been monitored for many years, including detailed information included in the budget process and reports to the Pensions Committee.
34. The Fund has followed CIPFA guidance and best practice on accounting for and disclosure of investment costs and was one of the early adopters of CIPFA's Code of Practice on Local Authority Accounting in the United Kingdom and the associated guidance.
35. With regard to private market investments the Fund's approach is ahead of the guidance and templates available.
36. The further roll-out of the Code of Transparency is expected to bring some minor benefits to the Fund, particularly on the consistency of information provided by managers and on implicit costs.
37. The Fund's approach in this area has been commended by the external auditors, Ernst and Young and before that PriceWaterhouseCoopers.

Recommendation

38. The Local Pension Board is asked to note the report.

Cost Transparency

The following is a list of the background papers (excluding exempt papers) relied upon in the preparation of the above report:

Background Paper	File Ref:	File Location
Code of Transparency		http://www.lgpsboard.org/index.php/structure-reform/cost-transparency