



Rent v Build and Own an Operator?

2nd September 2016

What we will cover

- 1) Recap: Proposed Pool Structure
- 2) The CIV Operator
- 3) Rent v Build and Own
- 4) Drivers for making a decision?
- 5) Officer recommendation
- 6) Implementation

Purpose of discussion today is to seek Chairmen agreement to officer recommendation

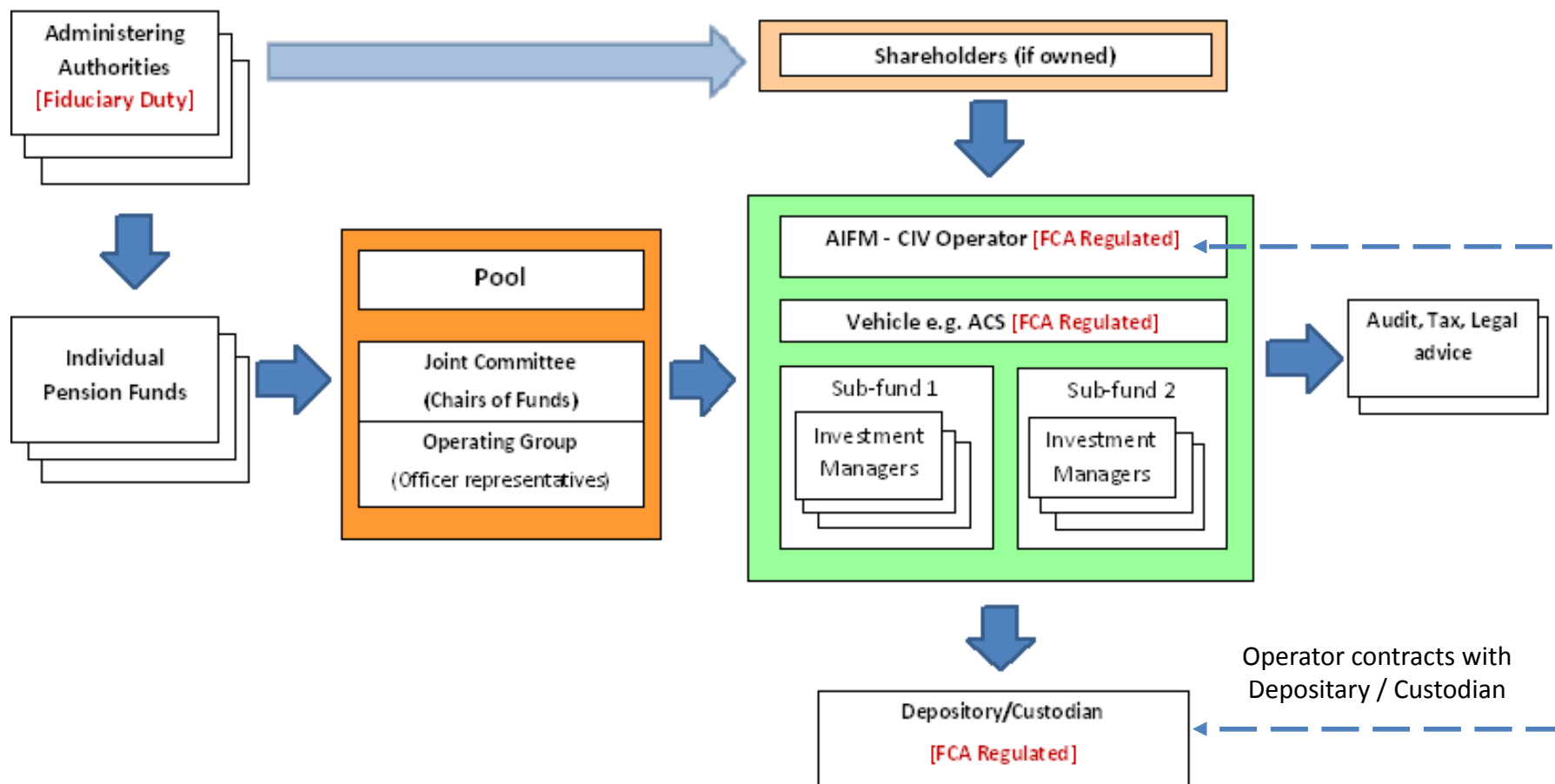
Recap: Proposed Pool Structure

ACCESS will establish an Financial Conduct Authority (FCA) authorised Collective Investment Vehicle (CIV) consisting of:

- an FCA authorised pooled fund **Operator*** and
- a regulated investment vehicles to house assets

*aka Alternative Investment Fund Manager (AIFM)

Collective Investment Vehicle (CIV)



Legal owner of assets: ACS / depository
Beneficial owner: individual Funds

The CIV operator - Functions

- 1) CIV operator is a single legal entity, either **owned** by the funds in the pool, or **rented** from a third party
- 2) The CIV Operator is regulated by the FCA
- 3) Its staff include FCA regulated roles e.g. Chief Investment Officer (CIO), Chief Risk Officer (CRO)
- 4) Investments are managed by authorised investment managers in FCA regulated investment vehicles such as an Authorised Contractual Scheme (ACS)
- 5) The CIV operator has regulatory responsibility for selecting and contracting with investment managers

Operator sets up and runs pooling vehicles

Responsibilities include

- Investment management arrangements
- Dealing in underlying investments
- Valuations
- Determining unit prices of pooled investments
- Dealing in units in the pooled vehicle
- Portfolio accounting
- Client reporting
- Getting the investment vehicles authorised (e.g.. deed, prospectus, depositary agreement, registrar agreements, trading agreements, IMA's)
- Contract with depositary and custodian
- Back office (e.g. administration & processing)
- Middle office (e.g. risk management and IT)

Whether own or rent, individual funds and Joint Governance Committee will want influence in defining their needs (eg sub-funds, managers, reporting)

Policies

- Liquidity
- Unit Pricing
- Leverage
- Risk Management
- Adverse Markets
- Best Execution
- Terms of Reference for Audit, Remuneration and Nominations, Risk and Joint Committees

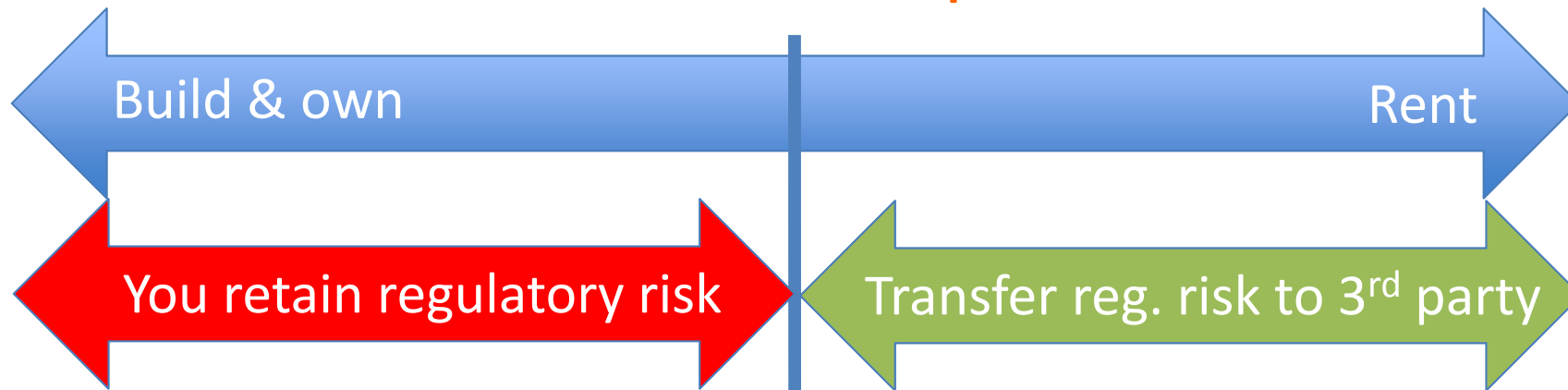
Regulated Roles

- Chief Investment Officer
- Chief Risk Officer
- Director
- Non-Executive Director
- Chief Executive
- Compliance Oversight
- Client Asset Oversight
- Money Laundering Reporting
- Customer Function

The CIV Operator - Options

- ACCESS authorities have no current capacity or capability internally to fulfil the roles required by the Financial Conduct Authority (FCA)
- ACCESS funds must acquire these resources either:
 - renting an established Operator or
 - building and owning the Operator

Rent v Build and Own – A Spectrum



Build max	Build "light"	Rent "light"	Rent max
No outsource apart from depositary/custody. Manage some or all money with "in-house" team.	Minimum staff on payroll. Outsource as much as possible. Use external investment managers. <i>eg London CIV</i>	Operator consults on investment manager picks. Funds retain investment strategy decisions. <i>eg Wales</i>	Administering authorities have a hands off role. Manager choices & asset allocation fully delegated to Operator

Operator must retain either investment management function or risk function – cannot outsource both. ACCESS has no investment management capability so if build would have to retain risk management in-house.

Drivers for making a decision



Regulatory Risk

Risks include:

- Significant fines
- Prison (up to 7 years)
- Reputational damage (to local authorities)
- Additional costs to put things right

Regulator may pursue:

- Corporate entity and its shareholders and/or
- Individuals (directors and officers)

Note: Increasing tendency to pursue individuals

Under rent model, all regulatory & operational risk transfers to third party Operator

Governance

	Build & own	Rent
1)	Operator appoints investment managers (after consulting JGC)	Same
2)	Change investment managers for poor performance (Operator <i>not</i> responsible)	Same
3)	Poor operational or administrative performance of Operator dealt with via Service Level Agreements. Ultimately Shareholders could sack and replace senior personnel.	Will have Service Level Agreements. Ultimate sanction is to terminate contract and replace with another 3 rd party or owned Operator company.
4)	If costs exceed budgets, any additional costs come back to shareholders / LGPS funds	If in scope of specification of services & SLA, Operator pays. If not in scope, Operator charges additional costs to clients (funds)
6)	Control over changes to Specification of services and service levels exercised by shareholders	This would require re-negotiation with 3 rd party Operator

Does build and own give greater control in areas that matter?

Timetable

	Build and own	Rent
1)	Funds & advisers decide sub fund structure	Same
2)	Funds and advisers set up ACCESS shell co. (to become FCA authorised)	Funds and advisers specify requirements for third party Operator procurement
3)	Funds hire personnel for regulated roles	Funds procure a third party Operator who provides staff in regulated roles
4)	Apply for FCA authorisation for Operator	Operator already has FCA authorisation
5)	Legals between administering authorities & Operator co, Service Level Agreements	Same except no shareholder agreement
6)	Operator sets up ACS and sub-funds and applies for authorisation	Same or Operator uses its existing vehicles and FCA authorisations
7)	Operator procures and contracts with its suppliers eg depositary, custodian, etc	Same except Operator likely to have existing supplier relationships & contracts*
8)	Operator appoints investment managers (after consulting JGC)	Same
9)	Transition assets	Same

Consideration between build from scratch vs already built and tested Operator model and amount of resource req reliance on third party to implement

Outline Timetable (Build and Own)

TASKS	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Plan, resource plan, budget Establish interim governance	Green	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue
Appoint legal and tax advisors	Green	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue
Search, select & hire senior staff	Green	Green	Green	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue
Procurement of depository, custodian, asset servicer	Light Blue	Yellow	Green	Green	Yellow	Light Blue	Light Blue	Light Blue	Light Blue
Establish office, IT, processes	Light Blue	Light Blue	Yellow	Green	Green	Yellow	Light Blue	Light Blue	Light Blue
Prepare & submit application for authorisation of Operator	Light Blue	Light Blue	Yellow	Apply	Green	Author-ised	Yellow	Light Blue	Light Blue
Preparation of application and authorisation of ACS*	Light Blue	Light Blue	Light Blue	Yellow	Green	Apply	Green	Author-ised	Light Blue
Select phase 1 investment mgrs	Light Blue	Light Blue	Light Blue	Light Blue	Yellow	Green	Yellow	Yellow	Light Blue
Operator and ACS goes live	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Yellow	LIVE
Transition assets	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Light Blue	Yellow	Green

Best case is at least 2 years to build – starting & and no contingency



Denotes greater uncertainty due for example to dependencies on earlier steps




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Effective • Collective • Investment

Outline Timetable (Rent)

TASKS	Q4 2016	Q1 2017	Q2 2017	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018
Plan, resource plan, budget Establish interim governance									
Appoint legal and tax advisors									
Operator: specify requirements and carry out procurement*			Appoint						
Preparation of application and authorisation of ACS*			Apply		Author-ised				
Select phase 1 investment mgrs									
Operator and ACS goes live							LIVE		
Transition assets									

Under rent model, Operator already FCA authorised
Rent will take about six months less

*Under rent, operator would contract with a depositary and set up an ACS

 Denotes greater uncertainty due for example to dependencies on earlier steps

Drivers – Comparison # 1

Factor	Build & own	Rent	
Regulatory Risk	Severe penalties (including fines and imprisonment) and reputational risk.	Transfer regulatory risk to Operator	
Governance – accountability	Additional shareholder control	Able to change to another third party supplier or owned Operator.	
Governance – mgr selection	Operator legally responsible but consults clients	Same	
Future Proof/ Long Term	Shareholder control enables changes in functionality and services if required. “Sacking” Operator more difficult but able to sack and replace senior personnel. ‘Remedy’ of issues may be difficult. Retain operational risk.	Would need to re-negotiate specification if changes required. Could replace 3 rd party with owned Operator in future.	
Timescales	Potentially 18-24 mths	Potentially 12-18 mths but possibly longer if Operator builds LGPS specific operator company and needs to set up ACS.	
Market	Staff recruitment and retention challenges. Key personnel risk. Significant salaries	May be limited providers - market needs tested. Currently aware of one major non-fiduciary (‘rent-light’) supplier but other large suppliers likely to ensure offering meets specification.	
Supplier Risk	Still likely to outsource some functions	Reliant on industry. Robust contract and Service Level Agreements required to ensure service standards.	
Commerciality	Limited opportunities, but comparable to other pools	No	

Drivers – Comparison # 2

Factor	Build & own	Rent	
Cost to establish and run	<ul style="list-style-type: none"> Regulatory capital - 10m euros (argue case for reduction) Set up - est £3-5m Ongoing - est £3-5m per annum 	<ul style="list-style-type: none"> Regulatory capital –third party Operator provides Set up - procurement & legal costs only Ongoing – similar in short term. Operator economies of scale but profit margin. Ongoing – could be higher in long term if fees based on Assets Under Management and not capped. 	
Officer resource to implement	<ul style="list-style-type: none"> Significant amount of time & effort by administering authority officers to set up (even with support from external advisers). Strain on business as usual running of funds. 	<ul style="list-style-type: none"> Less officer resource needed to establish. Still need to specify requirements and run a procurement exercise. 	

Presentation by Capita

Drivers – Which is right for ACCESS? # 1

Factor	Build & own	Rent	Comments
Regulatory Risk	Severe penalties (including fines and imprisonment) and reputational risk.	Transfer regulatory risk to Operator	Rent better
Governance – accountability	Additional shareholder control	Able to change to another third party supplier or owned Operator.	
Governance – mgr selection	Operator legally responsible but consults clients	Same	Similar
Future Proof/ Long Term	Shareholder control enables changes in functionality and services if required. “Sacking” Operator more difficult but able to sack and replace senior personnel. ‘Remedy’ of issues may be difficult. Retain operational risk.	Would need to re-negotiate specification if changes required. Could replace 3 rd party with owned Operator in future.	Build and own could give greater long term flexibility
Timescales	Potentially 18-24 mths	Potentially 12-18 mths but possibly longer if Operator builds LGPS specific operator company and needs to set up ACS.	Lesser importance?
Market	Staff recruitment and retention challenges. Key personnel risk. Significant salaries	May be limited providers - market needs tested. Currently aware of one major non-fiduciary (‘rent-light’) supplier but other large suppliers likely to ensure offering meets specification.	
Supplier Risk	Still likely to outsource some functions	Reliant on industry. Robust contract and Service Level Agreements required to ensure service standards.	Exists with both
Commerciality	Limited opportunities, but comparable to other pools	No	Lesser importance

Drivers – Which is right for ACCESS # 2

Factor	Build & own	Rent	Comments
Cost to establish and run	<ul style="list-style-type: none"> Regulatory capital - 10m euros (argue case for reduction) Set up - est £3-5m Ongoing - est £3-5m per annum 	<ul style="list-style-type: none"> Regulatory capital –third party Operator provides Set up - procurement & legal costs only Ongoing – similar in short term. Operator economies of scale but profit margin. Ongoing – could be higher in long term if fees based on Assets Under Management and not capped. 	Rent better at set up but ongoing may be higher
Officer resource to implement	<ul style="list-style-type: none"> Significant amount of time & effort by administering authority officers to set up (even with support from external advisers). Strain on business as usual running of funds. 	<ul style="list-style-type: none"> Less officer resource needed to establish. Still need to specify requirements and run a procurement exercise. 	Rent better as puts less reliance on officer resource and reduces implementation risk

Key findings

- 1) It would be possible to build an owned Operator, most likely along the lines of the “light” model adopted by London CIV which still has a heavy dependence on third party suppliers.
- 2) This might cost less in the longer term but is probably more difficult to implement in the short term (not least the necessary recruitment)
- 3) Build and own still retains some third party supplier risks
- 4) Build and own also brings all of the regulatory risk (potential penalties and reputational risk) on to the owning administering authorities and individuals as directors
- 5) We are not convinced that ownership gives any greater control than rental in areas most important to ACCESS such as involvement in decision making (eg manager selection).

Officer Recommendation

- The unanimous recommendation by officers is to **rent** initially.
- Under the rental option regulatory and operational risk transfers to the Operator.
- Renting initially leaves flexibility in future to continue to rent or change to an owned model. Factors that will affect views in future include:
 - experience of renting;
 - the future market for 3rd party suppliers;
 - running costs of rental; and
 - needs of Funds.

Mitigations

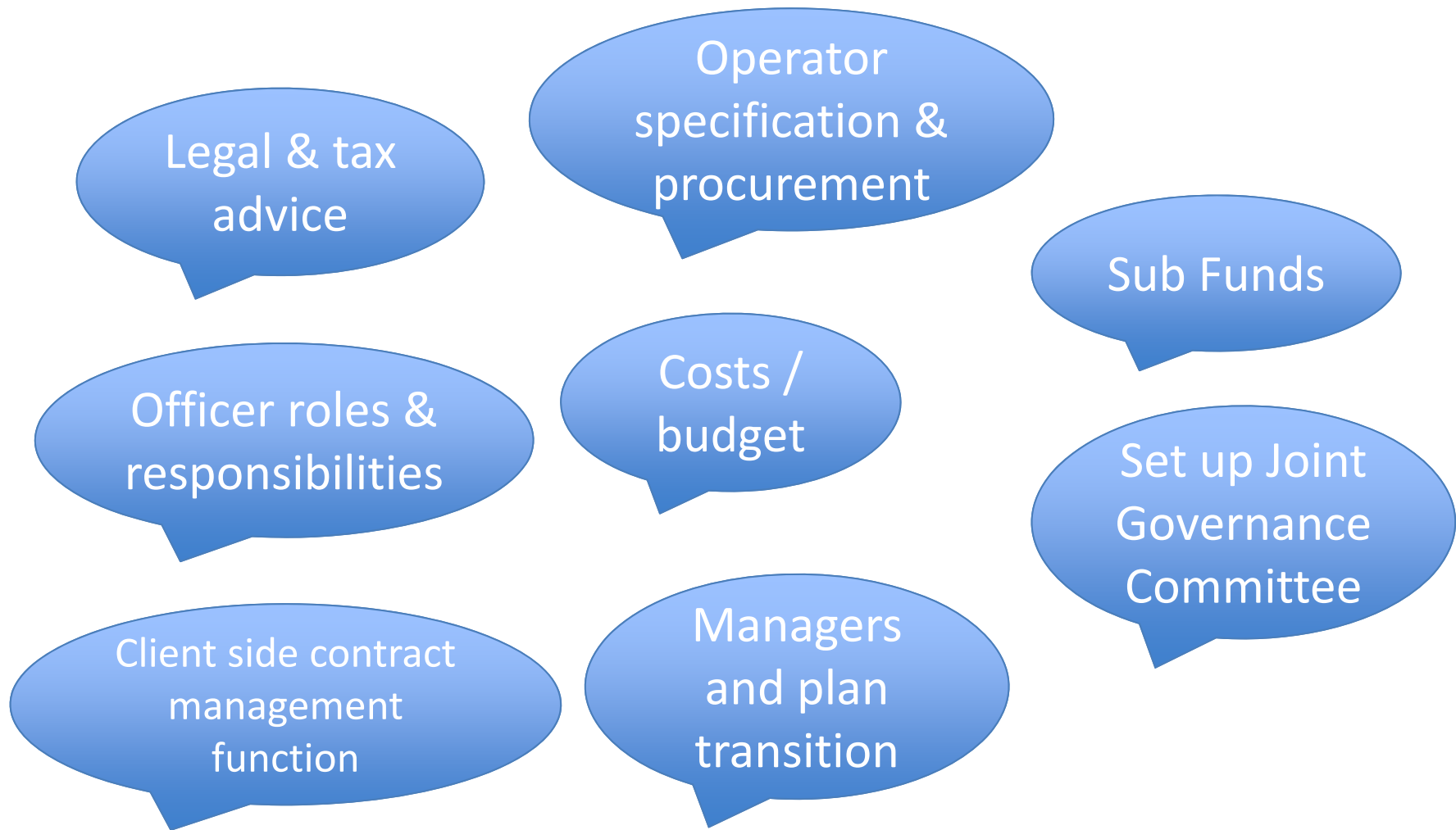
- 1) Due to concerns about the current limited number of suppliers, there should be a well designed “**exit plan**”, making transfer to an alternative third party supplier or an owned entity as straightforward as possible. (See following slides for details.)
- 2) The **specification** of Operator requirements for procurement is a critical task.
 - Care is necessary to ensure the services specified are only those needed (no more, no less); that there are appropriate contractual protections for ACCESS; and that the ACCESS funds have the required involvement in decision making within the boundaries allowed under Regulation.
 - Careful consideration will be given to ensure an appropriate charging structure that delivers value for money.
- 3) External **legal advice** from a firm experienced in this field will be required to support the specification, procurement and implementation phases.
- 4) A strong client side **contract management** function will be necessary.

Mitigations – “exit plan”

The specification for the procurement of the Operator should include features along these lines:

- 1) Requirement for Operator to procure Depositary / Custodian
- 2) Fixed term of say 5-7 years + option to extend + triggers for change before end
- 3) Bids should break the quoted price into components including:
 - a) operator service;
 - b) depositary costs;
 - c) custodian costs; and
 - d) any other significant supplier costs
- 4) Where there is an existing relationship with its suppliers (e.g. depositary / custodian), bidders must describe the due diligence undertaken prior to appointment of those suppliers. If the Operator is appointing or changing one of its major suppliers it should consult ACCESS to explain short-list and criteria for selection.
- 5) On termination of Operator contract, ACCESS will have the option to novate / transfer the Operator’s supplier agreements (eg depositary & custodian) to new Operator (eg an ACCESS owned entity).

Implementation project wide & complex



Significant support needed from officers over and above their day job

Immediate next steps under build or rent

- 1) Government feedback on submission
- 2) Detailed project plan, resource plan and budget.
- 3) Start project implementation
- 4) Define roles and responsibilities of JGC in a TOR*
- 5) Define roles and responsibilities of officers supporting JGC and managing Operator arrangements*
- 6) Update MoU as necessary for implementation phase*
- 7) Joint Governance Committee established in “shadow” form.
- 8) Specify Operator requirements* (including functions required, sub-funds needed, exit terms, etc)
- 9) Start build or procurement of Operator

Go Live in 2018

*Important that MoU, ToR and Operator spec dovetail

Any Questions?

Principles

The participating authorities reflect a strong commitment to the project and share an approach to achieve common objectives based on a clear set of guiding principles.

Collaborative	Risk management	Objective evidence based decisions
Equitable voice in governance	Professionalism	Equitable cost sharing
No unnecessary complexity	Evolution and innovation	Value for money

Democratic accountability and fiduciary responsibility are vital



ACCESS
Effective • Collective • Investment

Estimated establishment and running costs

PROVISIONAL ESTIMATES OF ADDITIONAL COSTS		
Regulatory Capital	10m euros	Our current advice is that this cannot come from pension fund assets and administering authorities must write a cheque deflecting tax-payer money away from services. If rent, supplier provides capital but charges the cost of capital to clients via fees.
Establish CIV	Build c£3-5m Rent c£1m+	Provisional estimates. Includes project management, legal, tax and other advisory costs and internal costs associated with establishing or procuring CIV operator and pooling vehicles.
Running CIV	c£3-5m pa	Assume similar between build and rent in short term. Build and own less costly in the long term. Sources: Initial price indications from supplier 1-2bps per annum and comparison with London CIV (building to 12 professional staff and paying 3 rd parties for services eg investment fund administration)
Additional officer resource	£0.5m per annum	Client liaison function managing operator contract (SLAs), monitoring operator performance (KPIs), reporting, support and advice to pool's Joint Governance Committee.
Reduction in existing costs?	Low	Some costs including selecting and contracting managers and custody transfer from individual funds to the Operator. In theory, savings from procurement of managers since done once on behalf of all participating funds (although LGPS collaboration has already moved suppliers e.g. passive procurement examples).