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Border to Coast Pensions Partnership

Revised Advice Note on Regulatory Capital and Loans

12 January 2017

This advice note has been prepared solely for Border to Coast Pensions Partnership (and its participating authorities), and unless expressly agreed in writing, we do not accept liability to any other person in respect of the advice provided.

The advice looks at the regulatory and pension fund implications of providing regulatory capital for Border to Coast Pensions Partnership Limited (when formed) ("BCPP"). The advice does not consider tax or accounting issues relating to the provision of regulatory capital by the authorities. Separate advice will be required from your financial advisers and auditors as necessary.

Detailed advice

1. **Background**

1.1 All FCA regulated businesses such as BCPP (when formed) are required to hold regulatory capital designed to protect the solvency of the regulated entity. Regulatory capital must be held within the business in liquid assets.

1.2 We can provide detailed information on the rules overseeing the calculation of quantum of regulatory capital required. However, we have set out at paragraph 1.3 below a broad summary of the position (although the exact calculation will involve a number of other factors) and how the regulatory capital may be funded by the participating administering authorities.

1.3 The FCA has rules setting the minimum regulatory capital requirement for an Operator at €125,000 plus 0.02% of assets under management in excess of €250 million or ¼ of fixed overheads (whichever is greater), with a maximum regulatory capital requirement of €10 million. There are also rules governing cover for professional liability. We would expect BCPP to be at the top end of the regulatory capital requirements.

1.4 When considering how to fund the regulatory capital requirements, the BCPP Pool administering authorities need to consider both the source of the money they are intending to use to provide the capital, in particular whether this is LGPS pension fund money or not.

1.5 The FCA also prescribe the requirements for that capital. At least 50% must be equity with that equity component and any debt component must have certain characteristics, e.g. subordination of loans and non-redeem-ability of shares.

1.6 Authorities also need, therefore, to consider the form of the funding, in particular whether the money is to be injected by way of a loan to or equity in BCPP. The use of pension fund money may affect the form of the funding, in particular for the administering authority that admits BCPP to its pension fund.

2. **Funding Regulatory Capital Using Pension Fund Money**

2.1 If any administering authorities are considering funding their share of the regulatory capital by using money from their LGPS pension fund then there are various factors to consider.

2.2 As a basic starting point, under the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 ("the Investment Regulations"), an administering authority must formulate an investment strategy in accordance with statutory guidance. The authority's investment strategy must include, amongst other things:

2.2.1 a requirement to invest fund money in a wide variety of investments;

2.2.2 the authority's assessment of the suitability of particular investments and types of investments; and

2.2.3 the maximum percentage of the total value of all investments of fund money that it will invest in particular investments or classes of investment.

2.3 The authority's investment strategy may not permit more than 5% of the total value of all investments of fund money to be invested in entities which are connected with that authority within the meaning of section 212 of the Local Government and Public Involvement in Health Act 2007. This hinges upon whether, according to proper practices in force at that time, financial information about BCPP must be included in the administering authority's statement of accounts for the financial year in which that time falls. This is an accounting question rather than a legal question, although given that each administering authority will only own one-twelfth of BCPP's shares, we think it is unlikely that BCPP will be connected with any administering authorities for the purposes of section 212. However, please note the separate employer-related investment rules below.

2.4 Investment strategy statements under the Investment Regulations must be published no later than 1st April 2017 and so new statements will all be in place before any regulatory capital needs to be provided to BCPP.

2.5 Each administering authority may need to have regard to these issues when formulating its Investment Strategy Statement ("ISS") to ensure any proposed pension fund investment (in whatever form) is permitted within the terms of the ISS. If not, the ISS may need to be amended to allow the investment.

Fiduciary Duties

2.6 When making any investment, an administering authority also needs to consider its overriding fiduciary duties to seek the best returns for the fund and to ensure the investment represents an appropriate use of fund monies. An administering authority may wish to consider the extent it can take into account the wider cost-savings that BCPP will generate in the round when considering any option to use fund money to provide regulatory capital. We also consider below how returns on regulatory capital, for example interest on the capital, can be returned to the administering authorities.

Providing Regulatory Capital By Way of a Pension Fund Loan to BCPP

2.7 The word investment is not specifically defined in Investment Regulations and must be given its ordinary meaning. We believe that the ordinary meaning would be wide enough that a loan to a different body would be an investment for the purposes of the Regulations (subject to the 5% limit referred to at paragraph 2.3 above if applicable and any separate employer-related investment restrictions).

Providing Regulatory Capital By Way Pension Fund Investment in Equity/Shares of BCPP

2.8 We also believe that an investment in shares of BCPP any one body would be a permitted investment under the Investment Regulations (subject to the 5% limit referred to at paragraph 2.3 above if applicable and any separate employer-related investment restrictions).

Employer Related Investments

2.9 Irrespective of the applicability (or otherwise) of the restrictions under the Investment Regulations referred to at paragraph 2.3 above, Section 40 of the Pensions Act 1995 (Restriction on employer-related investments) states separately that the trustees or managers of an 'occupational pension scheme' (including the LGPS) must secure that the scheme complies with any prescribed restrictions with respect to the proportion of its resources that may at any time be invested in, or in any description of, "employer-related investments" as defined in section 40(2) to include:

2.9.1 shares or other securities issued by the employer or by any person who is connected with, or an associate of, the employer;

2.9.2 land which is occupied or used by, or subject to a lease in favour of, the employer or any such person;

2.9.3 property (other than land) which is used for the purposes of any business carried on by the employer or any such person;

2.9.4 loans to the employer <u>or any such person</u> [see comments below]; and

2.9.5 other prescribed investments.

2.10 Whilst the provisions of the section appear to be drafted for private sector pension schemes, an 'occupational pension scheme' still covers the LGPS and despite the existence of the restrictions within the LGPS Regulations, we still believe that the employer-related investment restrictions are still relevant as a 'manager' of an occupation pension scheme would cover an administering authority.

Restrictions on Use of Loans

2.11 Regulation 16 of The Occupational Pension Schemes (Investment) Regulations 2005 requires each LGPS fund to be treated as a separate scheme for the purposes of the Regulations.

2.12 Regulation 12 of 2005 Regulations goes on to state that (subject to regulations 14, 15, 15A and 16), none of the resources of a scheme/fund may at any time be invested in any "employer-related loan" which includes a loan to the 'employer' (i.e. the employer of persons in the description or category of employment to which the scheme in question relates) or "any such person" which we believe refers any person who is connected with, or an associate of, the employer (please see the exact definition above).

2.13 Therefore, if BCPP is a participating scheme employer in an LGPS fund of one of the administering authorities then that administering authority could not loan monies from its pension fund to BCPP because BCPP would be an employer in that authority's fund (please see our separate advice note dated 20 December 2016 on the options for BCPP to participate in the LGPS as a scheme employer).

2.14 The position is less restrictive for the other administering authorities if BCPP is not a participating scheme employer in their pension funds. However, the position will hinge upon whether BCPP is 'connected with' or an 'associate of' those administering authorities (in their capacity as LGPS scheme employers) for the purposes of the Insolvency Act 1986.

2.15 In the case of the BCPP Pool, we believe that BCPP will not be so connected or associated because each administering authority only controls one-twelfth of the shares of BCPP so does not exercise control (as defined) over BCPP and therefore would not be connected with (or an associate of) BCPP. One-third control is the minimum level to meet the control requirements.

2.16 Therefore, administering authorities (other than the authority that administers the pension fund in which BCPP actually participates) could potentially loan money from their LGPS pension fund to BCPP without breaching the employed-related investment restrictions. However, this would mean that not all of the BCPP Pool administering authorities would be able to fund their share of the regulatory capital in the same way which may not be desirable from a consistency point of view. However, this could be managed by the creation of non-voting 'B' shares in BCPP so that the administering authority investing wholly by way of equity does not get greater voting rights than the authorities investing by way of a loan (and lower level of equity).

Restrictions on the Use of Equity

2.17 Subject to the prohibition on employer-related loans, Regulation 12 of the 2005 Regulations states that subject to regulations 13 and 16, not more than five per cent. of the current market value of the resources of a scheme/fund may at any time be invested in other employer-related investments. This would include shares issued by the employer (or by any person who is connected with or an associate of an employer).

2.18 Therefore, irrespective of the 5% restriction in the Investment Regulations (which we do not believe will be applicable to BCPP), the 2005 Regulations would impose a 5% limit if the investment constitutes an employer-related investment. However, as above, this is only likely to impact on the administer authority that admits BCPP as a scheme employer to its fund.

However, even where the 5% limit does apply, it is unlikely to cause any real issue give the level of regulatory capital each administering authority will need to provide compared to the size of its LGPS pension fund.

3. **Funding Regulatory Capital Using Non-Pension Fund Money**

3.1 Where general local authority reserves are being used to fund the regulatory capital requirements then the employer related investment restrictions set out above are not applicable because pension fund money is not be used to provide the regulatory capital.

3.2 However, each authority will need to consider its general fiduciary and public law duties before deciding to invest non-pension fund money in equity or to grant a loan to BCPP to fund its share of the regulatory requirements.

4. **Funding Regulatory Capital By Way of a Loan**

4.1 Where either pension fund money or non-pension fund money is being used to fund the regulatory capital requirements by way of a debt, in the form of a loan, then special terms will apply to any such loan.

4.2 The EU Capital Requirements Regulation which determines the composition of "own funds" under the FCA rules for an operator such as BCPP, set out various requirements for so-called Tier 2 instruments, which may be subordinated loans. The following should be noted, in particular:

4.2.1 The loan must not be made by an entity in which the operator has participation in the form of ownership, direct or by way of control, of 20% or more of the voting rights or capital in that entity;

4.2.2 the claim on the principal amount under the loan must be wholly subordinated to claims of all non-subordinated creditors; and

4.2.3 the loan must have an original maturity of at least five years and must not include any incentive for the principal amount to be repaid by an operator prior to the loan's maturity.

5. **Returning Interest Earned On Regulatory Capital Held By BCPP**

5.1 Regulatory capital may be invested in liquid assets which are assets that:

5.1.1 are readily convertible to cash within one month; and

5.1.2 have not been invested in speculative positions.

5.2 The FCA cites the following as examples of liquid assets: cash and "*readily realisable investments*" that are not held for short-term resale, and debtors.

5.3 The FCA Rulebook defines a readily realisable investment as:

5.3.1 a government or public security denominated in the currency of the country of its issuer;

5.3.2 any other security which is:

5.3.2.1 admitted to official listing on an exchange in an EEA State; or

5.3.2.2 regularly traded on or under the rules of such an exchange; or

5.3.2.3 regularly traded on or under the rules of a UK exchange; or

5.3.3 (c) a newly issued security which can reasonably be expected to fall within 5.3.2 when it begins to be traded.

5.4 The return on capital can be returned to investors provided that:

5.4.1 it does not reduce the amount of capital below the minimum limit; or

5.4.2 does not otherwise interfere with its loss absorbency in the event of insolvency or bump it up the order of priority in an insolvency.

5.5 In our view, the payment of interest earned by investing regulatory capital can be returned by BCPP to the administering authorities as investors and would not fall foul of the above requirements. This could be done by way of payments under a loan agreement or by way of a dividend if the regulatory capital is provided by way of equity.

6. Funding Capital Expenditure By Way of a Loan

6.1 BCPP as a company is also free to take out a loan to fund its general capital expenditure requirements (unrelated to regulatory capital) should the need arise. This could be from a third party such as a bank or from an administering authority using general authority funds or LGPS pension fund monies. Where money is loaned from an LGPS pension fund then the same issues as highlighted in section 2 above will apply in exactly the same way. These restrictions apply to loans generally not just to loans providing regulatory capital.

6.2 Please be aware that approval for BCPP to take out a loan may be a reserved matter under the Shareholders' Agreement depending on the level of the loan and/or who the loan is from. The reserved matters are still under negotiation.

7. Summary

7.1 In general terms, LGPS fund money can be used to regulatory capital by way of a loan or shares, although the administering authority that admits BCPP as a scheme employer to its pension fund will not be able to make a loan to BCPP from the fund but could invest via shares in BCPP (subject to the 5% employer-related investment restriction).

7.2 Where non-pension fund money is being used, the employer related investment restrictions do not apply.

7.3 Where regulatory capital is provided by way of any loan then special terms will apply to the form of the loan designed to ensure that the loan is deeply subordinated and has an original maturity of not less than five years. Not all of the capital be provided by way of loan so some equity will be required.

7.4 Interest earned on regulatory capital can be returned to the administering authorities provided the level of the regulatory capital does not fall below the required level.

7.5 BCPP may take out separate loans to fund its general capital expenditure requirements.

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