

Response to Markets in Financial Instruments Directive II Implementation: Consultation Paper III

Purpose

For decision.

Summary

The Financial Conduct Authority (FCA) is consulting on the implementation of the Markets in Financial Instruments Directive II (MiFID II).

This implementation will impact on councils' ability to invest in a wide range of financial instruments and this paper proposes a formal response on the issues that directly affect local authorities.

Recommendation

That the LGA Resources Board agree the draft response to the consultation attached at **Appendix A**.

Action

That member's comments are reflected in the response before it is submitted to the Financial Conduct Authority.

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Background

1. The Markets in Financial Instruments Directive II (MiFID II) is a package of EU legislation, introduced in 2014, which regulates both retail and wholesale investment business in the UK. The aim of the MiFID legislation is to strengthen protection for investors. In this case investors includes local authorities and local authority pension funds. Under the proposals, pension fund authorities are treated as a separate investor from the authority that hosts them.
2. On the 29 September 2016, the Financial Conduct Authority (FCA), published a consultation on how the legislation will be implemented in the UK. There are some proposals in the consultation which go far beyond the basic legislation and therefore should be seen as discretionary for the UK. The proposals would reclassify the status of local authorities and this will have a major impact on the ability of local authorities to invest in financial instruments other than (in many cases) basic bank deposits. It will, for example, make it difficult for local authorities to lend to each other despite the fact that local authorities in the UK have a robust track record of effective risk management with regard to investment and in respect of their pension funds considerable experience across a wide range of asset classes.
3. The proposed response from the LGA is attached at **Appendix A** for the Board's approval. It will also be submitted to the Local Government Pension Committee. This is a robust response highlighting many serious difficulties with the approach proposed by the FCA.

Key proposals in the consultation affecting local authorities

4. Not all elements of the consultation, which closes on 4 January 2017, are relevant to local government (the parts specifically directed at local authorities are chapter 4, pages 36 to 41, which covers client categorisation of local authorities. Page 150 - 162 in the appendix goes into further details of this. Estimated costs to councils are in para 102 – 104, on pages 154/155).
5. There are two specific questions aimed at local authorities. These are:
 - 5.1. Question 16 - Do you agree with our approach to revise the quantitative thresholds as part of the opt-up criteria for local authorities by introducing a mandatory portfolio size requirement of £15million? If not, what do you believe is the appropriate minimum portfolio size requirement, and why?
 - 5.2. Question 17 - Do you agree with our approach to extend these proposals to non-MiFID scope business? If not, please give reasons why.
6. As outlined above, the FCA are consulting on the implementation of the directive, not on the directive itself. The point at issue is *how* the directive is implemented, not *whether* it is implemented. However, the proposals by the FCA that affect local authorities go beyond what is in the original EU legislation.

7. The effect of these proposals is to categorise all local authorities, including pension funds, as “retail” clients. Currently all local authorities are “per se professional” clients, which gives them access a range of investment products. Retail clients are severely limited in their investment options and categorisation as “retail” will have a major impact on local authorities’ ability to invest. In the case of pension funds it is hard to see how they could manage their investment strategies properly or be able to meet the Government’s expectations on investment in local infrastructure.
8. The implementation allows local authorities to opt up to professional status, and it is likely that the vast majority of local authorities, and certainly all pension funds, will want to do this. However, as outlined in the draft response, the tests proposed by the FCA to enable opt up are so difficult that they will prevent many, if not all, local authorities from opting up.
9. The FCA is proposing a minimum value of investment portfolio of £15 million as being a cut-off point; any local authorities with an investment portfolio of less than £15 million will automatically not qualify for opt up to professional status and will have to remain as retail status. This is likely to prevent a large number of local authorities from being able to opt up – and due to the variations in cash flow over a year, it is quite likely that this will include large authorities as well as small. The FCA’s own analysis (which was based on specific year end “snapshot” figures) was that about half of UK local authorities would be excluded by the £15 million limit. This includes 12 single tier authorities, and 57 shire districts in England. The calculation included cash deposits and these will vary with cash flows so depending on the time period for calculation of the size of the investment portfolio, it is quite possible that many more local authorities could be excluded (the similar “snapshot” taken at the end of the following year pointed to a different group of local authorities – including some very large councils – being excluded). The FCA needs to rethink this point. The figure included in the EU legislation is 500,000 euros, anything above that is the FCA’s proposal.
10. The other conditions for opt up are not included in the formal questions, but the proposed response addresses these and concludes that most authorities, including pension funds, will not be able to meet enough of them and so will not be able to opt up to professional status. As stated, this is likely to be a major problem for local authorities, particularly pension funds.

Recommendations

11. That the Resources Board comment on and approve the contents of the draft consultation response attached at **Appendix A**.

Implications for Wales

12. This consultation from the FCA is aimed at all UK local authorities and applies to them all equally – whether England, Wales, Scotland or Northern Ireland. This is explicit in the analysis carried out by the FCA which looks at all UK local authorities. The impact on Welsh local authorities is therefore the same as the impact on English local authorities.

Financial Implications

13. This is part of the LGA’s core programme of work and as such has been budgeted for.