Leicestershire County Council

LOCAL PENSION COMMITTEE – 22ND JANUARY 2016

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

LOCAL GOVERNMENT PENSION SCHEME INVESTMENT REFORM

Purpose of the Report

1. To inform the Committee of the latest position in respect of the on-going national discussions into the future shape of the investments of the Local Government Pension Scheme (LGPS), and to recommend a strategy in respect of becoming part of an investment pool.

Background

2. In May 2013 the then-Local Government Minister made it clear in a speech that the structure of the LGPS was being considered, with Fund mergers a possible option. This speech was followed by a 'Call for Evidence' consultation that focused on the management of deficits and investment efficiency.

3. In May 2014, and following analysis of the responses received from the Call for Evidence, a further round of consultation was launched. This consultation ruled out forced Fund mergers in the near term and focused on the possibility of asset pooling (possibly via the formation of a small number of Common Investment Vehicles) and the increased use of passive management, both of which were thought to offer potentially significant savings in investment management fees across the LGPS.

4. The Summer Budget of July 2015 contained the following announcement:

   "The government will work with the Local Government Pension Scheme administering authorities to ensure that they pool investments to significantly reduce costs, while maintaining overall investment performance. The government will invite local authorities to come forward with their own proposals to meet common criteria for delivering savings. A consultation to be published later this year will set out those detailed criteria as well as backstop legislation which will ensure that those administering authorities that do not come forward with sufficiently ambitious proposals are required to pool investments."

5. Subsequent to the Budget, it became clear that there would be no formal consultation on the matter of asset pooling. Instead, discussions between individual Funds, representatives of Funds (such as the Local Government Association and investment consultants), the Department for Communities and Local Government (DCLG) and the Treasury were considered to form the necessary consultation.

6. In late November 2015 the Department of Communities and Local Government (DCLG) issued a document entitled 'Local Government Pension Scheme:

Investment Reform Criteria and Guidance'. This document had been widely anticipated and did not contain any surprises to those Funds that had been close to the discussions that had been taking place between the interested parties. A copy of the document is attached as Appendix 1 of this report.

7. The DCLG also issued two other documents on the same date. One was a response to the consultation referred to in paragraph 3 of the Criteria and Guidance document, and this is attached as Appendix 2. The other was a consultation named 'Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 which is attached as Appendix 3.

Investment Reform Criteria and Guidance

8. Whilst it has been clear for many months that a reform of the manner in which LGPS Funds invest their monies was inevitable, the publication of the document 'Local Government Pension Scheme: Investment Reform Criteria and Guidance' was the first time that the criteria against which the various options would be judged have been formally laid out.

9. The document sets out the following four key criteria:

A. Asset pools that achieve the benefits of scale – minimum size £25bn;
B. Strong governance and decision making – the governance structure should provide strong governance at both a local Fund level, and also at a pool level;
C. Reduced costs and excellent value for money;
D. An improved capacity to invest in infrastructure.

10. The criteria also stated that the pools should take the form of 'up to six British Wealth Funds'. It would actually be possible for the LGPS to form more than six pools and still meet the minimum size criteria for each one, but it is not thought likely that this will be accepted as an outcome.

11. There is a possibility that an exception may be made for the eight Welsh LGPS Funds (with combined assets of c.£13bn), with the intention that they will in future become the responsibility of the Welsh Assembly – as is the case in Scotland, where the Scottish Parliament has responsibility for the Scottish LGPS – but this is ultimately likely to be a political decision. If this does happen, it is by no means certain that the government would allow six pools for England.

12. A Common Investment Vehicle (CIV) already exists for the London Boroughs and although it will require some changes to meet the government's criteria (investing through it is currently optional, for example) there is little doubt that a London CIV will be one of the six pools. As a result, there are likely to be only five other pools allowed, and if Wales becomes one of these the number may be reduced to four. It is, however, difficult to envisage circumstances whereby the government will accept a sub-scale Welsh pool and not also allow five English (excluding London Boroughs) pools, given that there is a possibility that restricting this to four will bring certain diseconomies of scale and more difficult governance.

13. Under the guidance of Hymans Robertson, Leicestershire has been one of over 20 LGPS Funds that have been collaborating since August 2015 in an attempt to

influence government thinking into pooling, via direct meetings and through the production of a report that looked into various possible pooled investment structures. This report commenced as a number of ‘workstreams’ based on asset classes (equities, bonds, property etc.), styles of investment management (internal, passive etc.), or other factors (regional pooling, risk factors etc.), before being refined down to a proposal that all parties were in agreement with. The final version of the report, which is expected to have been published before this meeting but had not been at the time of writing this report, was much slimmed-down from the more detailed workstream reports, but does provide sufficient detail to explain why the final proposal was the preferred option.

14. Pools based on asset classes were ultimately not considered the optimal structure (with the exception of an infrastructure platform) for a number of different reasons – for example, active equities would have produced a pool that was simply too big to manage effectively, whilst others would have been too small. Although there were potential additional fee savings that could have been achieved by asset class pools these were fairly negligible, and governance of them would have been much more difficult than other options. The potential of having 90 Funds all represented on a management committee is unlikely to have led to efficient decision-making.

15. The preferred options of the Funds that were responsible for the report was as follows:

- 6 multi-asset, multi-fund pools;
- An infrastructure platform (which will include a number of different methods of investment) that will be available to the whole of the LGPS, and through which the LGPS will be expected to invest all future infrastructure monies.

16. Given the government’s inclusion of infrastructure as one of the four criteria, and given that having six multi-fund pools all trying to invest relatively modest amounts into the asset class is sub-optimal, a national infrastructure platform gives a potentially improved ability to invest successfully within the asset class. As an example, Co-investment with other investors or even direct investment in specific assets becomes more possible if there is a national infrastructure platform than if there are six LGPS multi-asset pools all looking for similar types of investment (and potentially competing with each other).

17. It should be made clear that none of the Funds involved has any wish to invest in infrastructure assets that do not offer returns, on a risk-adjusted basis, that they consider acceptable. A national infrastructure platform is not intended to be a method whereby the LGPS can fund the UK government’s required infrastructure spending, and unless these individual assets are attractive they will not be purchased. The onus is on the UK government to provide investments that have terms that are sufficiently attractive both in absolute terms and also relative to other available infrastructure investments. If this does not happen there is unlikely to be any LGPS investment in UK government infrastructure projects.

18. It was always considered likely that the DCLG considered ‘regional’ pools to be the default option if there was no common agreement across the LGPS, assuming that no other structure had clear advantages over it. During the period in which discussions have been taking place a number of ‘alliances’ have been formed within the LGPS and whilst many of these could be broadly described as regional, there

are others that are spread more widely on a geographical basis. As a result, the term ‘regional’ has been superseded by the term ‘multi-fund’, or ‘like-minded’.

Potential LGPS Pools and Proposals for the Leicestershire County Council Fund

19. The government is asking each Fund to put forward proposals for pooling scheme assets by 19th February which should include ‘a commitment to pooling and a description of their progress towards formalising their arrangements with other authorities’. These proposals will be assessed against the four criteria set out in paragraph 9 above. With this in mind, and given the speed at which potential pools were moving forward it was necessary for Officers to become involved in the on-going discussions.

20. The two potential pools that appear to fit Leicestershire’s broad investment beliefs and requirements best are one based on a grouping of Midlands Funds (with a working title ‘LGPS Central’) and one calling itself ACCESS (Collaboration of Central, Eastern and Southern Shires). There is no reason to suggest that Leicestershire could not work effectively with either of these groups, or indeed with a number of the other groups, but it has been necessary to focus on the one that appears to have the most positive points and to engage fully with that one.

21. It is officer’s belief that LGPS Central has a slight advantage over ACCESS. There remains the possibility of Funds being able to ‘switch’ pools between the initial February submission and the ‘refined’ submissions required in July, and it is probably the case that some Funds will do exactly this, but this should be considered a last resort. Unless there are very clear reasons why LGPS Central no longer looks attractive to Leicestershire, the intention is to remain actively involved in shaping the structure and governance of that pool as much as possible.

22. Within any collaborative arrangement it is important that the individual Funds all share common beliefs in many areas, including governance structures (and in particular one Fund-one vote), the long-term nature of investment decisions, their stance towards responsible investment, willingness to collaborate with other pools, the need to retain sufficient internal expertise, the necessity for internal investment arrangements to be judged on the same standards as external arrangements, and the need to be open and transparent with each other. On the basis of the three Officer meetings that have already taken place with other authorities committed to the LGPS Central pool, there appears to be a very solid agreement on these broad principles and many other factors.

23. There are currently eight LGPS Funds (including Leicestershire) that are part of LGPS Central, and six of these are the Funds that Leicestershire collaborated with in the joint appointment of an external passive investment manager. This appointment was very successful and proved the willingness of these Funds to work together towards a common goal. Whilst it is clear that the joint appointment of a manager is a much more straightforward project than the formation of an investment pool with a single governance process, there is at least some evidence that the Funds can collaborate without any friction.

24. The eight Funds have combined assets of £35bn, which is well above the government’s stated minimum pool size. With eight Funds, governance can be

effective without a single Fund having too much influence – having to get at least four other Funds ‘on board’ for any contentious issue will not be easy. There is also scope to accept another one or two Funds without causing undue governance issues, and the extra value of assets may well be beneficial in helping to reduce costs further (although the LGPS Central does not actually need to attract any other Funds to meet the required criteria). At a recent Officer meeting, two other Funds that have not yet decided their preferred pool were present.

25. A key difference between the LGPS Central pool and some of the others is that there will be a mix of internally and externally managed assets – three of the Funds currently manage a meaningful proportion of their assets ‘in house’ and the staff managing these assets will ultimately become employees of the pool. There will be no compulsion on the part of all Funds within the pool to have any of their assets managed internally for a number of years, and the continuation (or expansion) of internal management as an option will ultimately be judged on the same basis as external management.

26. Some of the other pools will be entirely externally managed, and it will be difficult for them to then build internal capability if it is proven to be successful within other pools; given that internal investment management is much cheaper than external, it seems sensible to be in a pool that has the capability to offer it. If it is not successful and cost-effective, it can be phased out and only those that have chosen to use it will have suffered in the interim period.

27. Of the Funds involved with the LGPS Central pool, the West Midlands Pension Fund is by far the largest at over £11bn. It is natural to have concerns over a potential desire on their part to exert undue influence over the operation of the pool (over and above the principle of one Fund-one vote), but there have been no signs so far that this is the case. In many ways, their size is an advantage to the pool, as it means that the government’s minimum required size can be reached easily without having to collaborate with another three or four funds which might make governance more difficult. In reality, there is a mutuality of need between the West Midlands Pension Fund and the other seven Funds involved, and this is an important factor.

28. There currently appear to be eight potential LGPS pools, so clearly not all will ultimately be accepted. These pools are:

- LGPS Central;
- Northern Powerhouse (West Yorkshire, Greater Manchester, Merseyside plus others);
- ACCESS (Norfolk, Northants, Cambridgeshire, Essex and others);
- London;
- Brunel (South West Counties plus Oxfordshire and the Environment Agency);
- Borders to Coast (Surrey, Cumbria, East Riding, Lincolnshire);
- Wales;
- London Pensions Fund Authority/Lancashire.

29. There are a number of Funds that have not yet committed to any of the pools, but at present three of the pools do not get near to meeting the minimum size criteria – Borders to Coast, LPFA/Lancashire and Wales. LGPS Central appears to be in a very strong position to be one of the six pools.

30. As an individual Fund it is very difficult to be actively involved with more than one pool and to still be taken seriously. In order to be able to exert full influence on the evolution of a pool, a clear commitment is preferable. Funds that initially fail to commit might find themselves in a weak position to have influence on the pool that they ultimately join, or may not even be accepted by the pool that they wish to join. Ultimately, the pools will wish to have strong and effective governance, and having too many Funds within a pool will make governance more difficult, so pools may later choose to restrict their size.

31. In addition to the above, there are two main reasons that LGPS Central appears to have advantages for Leicestershire, relative to any of the other pools. The first is the geographical proximity and the fact that Leicestershire has successfully worked with most of the other Funds very recently. The second is the inclusion of internal management within the pool from the start. It is not considered likely that Leicestershire will utilise this internal management option for a number of years, but if it does prove itself relative to external management options, it will lead to much bigger long-term savings than will be achievable via a pool that is predominately (or exclusively) externally managed. LGPS Central also appears to have a very solid commitment from enough other Funds that its probability of being accepted as one of the six ‘British Wealth Funds’ is high.

32. Whilst it is believed that the Leicestershire Fund is very well suited to LGPS Central, a ‘breakdown’ within that pool can never be entirely discounted. As a result, it is intended to remain involved, at the fringes, with ACCESS as a ‘Plan B’.

New Investment Regulations

33. In November 2015 a consultation entitled ‘Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulation 2009’ was issued. Responses to the consultation (which is attached as appendix 3) are required by 19th February 2015.

34. The LGPS is not a trust-based scheme, and as such operates under Regulations set up using Statutory Instruments. The current Investment Regulations are relatively short and include certain restrictions about what percentage of assets can be invested in certain types of assets. The existing Regulations do not cause the Leicestershire Fund to alter its preferred investment position, although some other Funds are closer to the current limits.

35. The move towards the pooling of assets within the LGPS gives the prospect of the use of different investment structures, and the risk that the current Investment Regulations will interfere with pools being set up in an optimal manner. As a result, it is proposed within the consultation that the Regulations should be amended to a model that is similar to the ‘prudent person’ principle that applies in trust based pension schemes. In broad terms this puts the onus on individual funds to determine a suitable balance of investments to meet its liabilities and to clearly articulate this within an investment strategy.

36. Whilst there will be certain changes required to the policy documents of the Fund that will be required if the proposed new Regulations come into force, these will not impact onto the actual investment operations of the Fund. The purpose of the

intention for the LGPS to utilise the ‘prudent person’ principle is to allow greater freedom for individual Funds to be able to implement their own investment requirements, and as such the changes are to be welcomed.

37. There is a second part of the consultation into potential new Investment Regulations that is arguably more contentious – the power of the Secretary of State to intervene in the *investment function* of a Fund. In broad terms, intervention will only be considered if a Fund is not complying with guidance or best practice and has no clear plans to rectify this situation. The main purpose of the Regulations is to act as ‘backstop’ legislation to require ‘those authorities who do not bring forward sufficiently ambitious plans to pool their investments’; in other words, to force any reticent Funds into an investment pool. Given government policy in the area of investment pooling and the possibility that some Funds may refuse to go along with this policy, backstop legislation is inevitable and should not be considered intrusive in the operation of a Fund’s investment strategy.

38. The power to intervene does exist for reasons other than an unwillingness to take part in asset pooling, but it is clear that it will only be used in extreme circumstances. As long as Funds that are felt to be not achieving reasonable standards are given the opportunity to improve their performance, intervention is reasonable. Leicestershire’s standards would need to drop very substantially before there became any risk of intervention.

Summary

39. There are a number of options available to the Leicestershire County Council Pension Fund in respect of future pooling of assets within the LGPS. Of the available options, for the reasons stated above, LGPS Central (a collection of eight Midlands-based Funds, if Leicestershire is included) has clear advantages over the others. There is a strong commitment from these Funds to progress to become one of the six ‘British Wealth Funds’ and all of the criteria will be met by the pool (including, crucially, the minimum asset value required).

40. The current consultation into the LGPS Investment Regulations should be viewed positively, as it improves future investment options for both individual Funds and future investment pools. The power of the Secretary of State to intervene in certain (limited) circumstances is an inevitability of greater investment freedom and a necessity in respect of the ability to deal with any Funds that refuse to join an accepted investment pool (i.e. one of the six ‘British Wealth Funds’).

41. Both the response to government on pooling proposals and the consultation into the LGPS Investment Regulations are required by 19th February 2016 and this is before the next meeting of the Local Pension Committee. Draft responses have not yet been produced as there are currently a number of on-going conversations with other Funds that are expected to see views shared before formal responses are prepared – in the case of asset pooling, there is likely to be a response from LGPS Central, as well as a response by Leicestershire as a stand-alone Fund, and it is important that these responses are not contradictory.

42. Although the Fund’s response to either of these issues is not expected to be particularly lengthy or technical. For the reasons stated it has not been possible to prepare drafts in advance of this meeting. It is, therefore, proposed that, following

consultation with the Chairman of this Committee, the Director of Finance be authorised to prepare and submit the responses and that copies be circulated to all members of this r Committee for information.

Recommendations

43. It is recommended that

a) A firm commitment is given by the Committee on behalf of the Fund to continue to work with the LGPS Central pool to put forward a proposal to become one of the six 'British Wealth Funds;

b) That the Director of Finance, following consultation with the Chairman of this Committee, be authorised to:

i. Respond to the government on its initial proposals for pooling scheme assets, detailing the Funds commitment to pooling and its progress towards formalising arrangements with other authorities to be part of a British Wealth Fund as agreed in recommendations (a) and (b) above; and

ii. Respond to the government's consultation 'Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulation 2009'.

Background Papers

None

Appendices

Appendix 1 - Local Government Pension Scheme: Investment Reform Criteria and Guidance'.

Appendix 2 - Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies

Appendix 3 - Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009.

Equal Opportunities Implications

None specific

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