Leicestershire County Council

LOCAL PENSION BOARD – 18 OCTOBER 2023

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

CONSULTATION: NEXT STEPS ON INVESTMENT

Purpose of the Report

1. The purpose of this report is to inform the Board of a consultation paper issued by the Department for Levelling Up, Housing and Communities (DLUHC) on 11 July 2023, titled “Next Steps on Investment” and an overview of the Fund’s response.

Policy Framework and Previous Decisions

2. The Fund is a participating scheme in the Local Government Pension Scheme (LGPS) Central Pool (Central) alongside Cheshire, Derbyshire, Nottinghamshire, Shropshire, Staffordshire, West Midlands and Worcestershire. As set out in the Investment Strategy Statement it is the Fund’s intention to invest its assets through Central as and when suitable pool investment solutions become available.

3. Central has been in operation since 1 April 2018. As at 31 July 2023 Leicestershire County Council Pension Fund (the Fund) has circa £2.2bn invested in Central, as well as over £350m in uncalled commitments which will increase its overall pooled exposure. Outside of Central the Fund has £942m (as at 30 June 2023) invested in low-cost passive equity with LGIM (Legal and General Investment Management). The Fund would consider these LGIM investments to be pooled given the investment management savings originally achieved from the joint procurement with other LGPS funds.

Background

4. The Government instigated the ‘pooling’ of pension funds in 2015 with the publication of criteria and guidance on pooling of LGPS assets. Administering authorities formed their own groups and eight asset pools were established, which are now all operational. The scale of each pool gives significant buying power in the investment market, that would not normally be accessible to individual funds.

5. In July 2023 the Government launched a long-awaited consultation seeking views on proposals relating to LGPS investments, covering asset pooling, levelling up, opportunities in private equity, investment consultancy services and the definitions of investments.

6. The consultation proposes to accelerate and expand LGPS pooling, setting a March 2025 deadline for funds to transition all listed assets, at a minimum, to their pool. The Government has also confirmed a target for funds to invest up to 5% of assets to support levelling-up in the UK and has set an ambition for funds to have 10% of their assets invested in private equity. The deadline for consultation responses was 2 October 2023.

7. The Local Pension Committee considered a report setting out the Fund's proposed stance on key issues at its meeting 8 September 2023 from which a response was provided to the consultation on behalf of the Fund following consultation with the Local Pension Committee Chairman. The response took into account key messages from the Committee which are set out later in this report.

Main themes of consultation

8. There are five key areas within the consultation on Local Government Pension Scheme (England and Wales): Next steps on investments. While the consultation does not look to mandate asset allocations and investment decisions, the Government has set expectations that funds set targets related to pooling, levelling up and private markets investments. Throughout the response to the consultation it was made clear that its first priority is looking for appropriate risk adjusted returns; if investments presented good value and risk adjusted returns, the Fund would invest.

9. There are arguments for and against the Government's proposals. From the Fund's perspective pooling and the benefits it receives in terms of value for money and net performance is supported. However, there remain some circumstances where there may be value in the Fund continuing to invest outside of the pool. The Fund's response emphasised the importance of funds retaining some flexibility to be able to take decisions that are different to other funds; a one-size-fits-all approach will mean that it is likely to fit no-one perfectly.

10. At the same time, it was recognised that if LGPS funds look to implement niche individual investment strategies there is a risk of dilution of economies of scale if pools try to offer too many investment options. There will be room and opportunity for further collaboration between partner funds, pools and investment advisors in product development and strategic asset allocation setting which will be key in driving pooling forward.

Asset pooling

11. The Government has made clear that it wishes to see pooling move further and faster to substantially increase scale and drive better value for money. It is the Government's view that benefits of scale are present in the £50-75bn range and improve up to £100bn, which could eventually lead to further proposals by the Government to subsume or merge pools.

12. Partner funds within Central have assets under management of £55bn. As at 31 March 2023, 49% of those assets have been transitioned to the pool, whereas another 32% are currently externally passively managed. When looking to compare pooling levels across the LGPS there is a clear lack of consistency with reporting what constitutes pooled, under pool management and not pooled, with some pools including investments like external passive products, which Central does not do.

13. Within the Fund's response it objected to any proposal to subsume Central into another pool or vice versa. This is largely due to cost, complexity, timing and issues around accountability and governance. Instead, there are plenty of opportunities remaining for collaboration with partner funds, investment advisors and pools to support the primary aims of funds and pooling objectives.

14. The Government proposed to set a deadline requiring administering authorities to transition all listed assets to their LGPS pool by March 2025. As presented to the Committee in June 2023 Leicestershire is the second most pooled fund within Central. As at 31 July 2023 the Fund has over £2.2billion in pooled products. While the Fund continues to hold £900m in external passively managed funds through LGIM. Historically, the Funds LGIM investments have been considered to be pooled given the savings originally achieved, which is unlikely to be bettered by Central given the scale of LGIM, and the breadth of products available.

15. There remains a lack of clarity over whether such low-cost external passive holdings can be classed as pooled, given the different approaches across pools. The Fund has requested that Government clarify that these low-cost passive holdings can be classed as pooled.

16. The response further highlighted that a deadline to pool is not achievable. While the Fund considers its strategic asset allocation annually, often asset allocations are most fundamentally reviewed following actuarial valuations; the next such valuation for the Fund being in March 2025. Fund's must also consider transition costs, timing and what is most appropriate for a fund.

17. The response instead highlights opportunities where funds and pools can collaborate further. This includes making the most of any areas where funds can align their approaches, such as involving pools in the development phase of the strategic asset allocation processes, while retaining ultimately any approval of the SAA at a local level. As well as consider whether it would be appropriate to procure one joint investment advisor firm per pool, which could support cost reduction and possible alignment of investment approaches.

18. The Government further proposes a requirement for administering authorities to have a training policy in place for Committee members. Given that the Fund already has a Training Policy in place is proposed that this be supported along with any additional formal guidance which can further support the Local

Pension Committee in discharging its functions.

19. The Government also proposes further guidance for reporting on pooling levels and net returns. The Fund in its response has stressed the importance that any comparison exercise recognises funds have different approaches to risk and return as dictated by their funding levels. There also needs to be guidance on how savings achieved are reported, which may be difficult if funds are not pooling like-for-like investments.

Levelling Up

20. The Government's Levelling Up White Paper (LUWP) sets out its ambition for LGPS funds to invest in projects that aim to tackle the uneven distribution of opportunity in the UK.

21. The consultation provides clarity on the definition of a "levelling up" investment, identifying 12 medium-term levelling up missions: living standards, research and development, transport, digital connectivity, education, skills, health, well-being, pride in place, housing, crime and local leadership. Local investment is defined as supporting **any** local area within the United Kingdom. The consultation asks whether respondents agree with the proposed definition. As highlighted earlier the Fund has stressed its primary purpose in paying pensions.

22. It will also be key that the Government clearly define what would contribute a 'measurable contribution', as it is hard to think of many UK based investments which would not feasibly fit in some way under the levelling up ambition, even if an investment was not made expressly for that purpose. However, as suggested at the Local Pension Committee by a member there may be value in Government seeking to better understand current LGPS investments within the UK, which may enable the Government to consider where it can support funds with their ambitions if objectives can be co-delivered alongside funds primary purpose.

23. The Government proposes amending regulations to require funds to set a plan to invest up to 5% of assets in levelling up the UK, including a timeline, and to report annually on progress against that plan. It is proposed that pool companies assist decision-making over investments made locally, in order to avoid any actual or perceived conflicts of interest between funds and administering authorities.

24. The Fund has disagreed with this requirement. Any investment would need to stand independently on its own merit and within the Fund's SAA and meet the fiduciary duty. There is also a concern that if all funds look to invest in this way it could result in pools and funds competing for the same investments. If there is not sufficient supply for opportunities this could result in higher bid prices, and ultimately lower returns.

25. While there are not currently reporting mechanisms to reflect levelling up missions, the Fund has previously worked with LGPS Central and external

investment managers to understand its exposure to the UK.

26. Within equity, infrastructure and property the Fund's investment in the UK is well above the UK's market share. It is important to note that it is not clear from the consultation which asset classes could be considered as part of the measurement of levelling up indicators which the Government will need to clarify. Across the Fund's portfolio UK exposure currently equates to circa 21%.

27. Given the estimated exposure to the UK across all asset classes, it is likely that the Fund already exceeds the 5% and therefore, if this proposal were to be implemented, the only impact on the Fund would result in increased reporting requirements from investment managers and LGPS Central which may ultimately result in increased costs and a reporting burden for an issue not directly linked with the Fund's fiduciary duty.

28. The Government has recognised many funds will already have some investments which contribute to levelling up, and in some cases, this may exceed 5%, and some funds may wish to increase their investment above this threshold, which "will be for funds to decide the appropriate level of investment and types of investments". The Fund would agree with this statement; however, this must ultimately precede all investment decisions and is a matter for local consideration and determination by the Local Pension Committee subject to the aim and purpose of the Fund, which is to maximise investment returns within reasonable risk parameters.

29. It is not the role of the Fund to put non-financial beliefs, such as political, ethical, moral, social, and local preference factors, above those of the employers funding the pension scheme.

30. By the Fund earning a commercial return it supports local authorities (and other employers) to keep employer contributions lower than they otherwise could be. This assists those employers that may wish to support local priorities directly and take into account non-financial factors over and above any requirements to achieve commercial returns. The Fund cannot do this as it is limited in its fiduciary duty and other factors that may complicate matters such as conflicts of interest, and additional governance and monitoring impact of each new manager appointment.

Investment Opportunities in private equity

31. As part of the Mansion House speech, the Chancellor laid out plans to make UK pensions capital available to support UK companies whilst seeking to boost the retirement incomes of pension savers. The initiative focuses on providing investment in high-growth, innovative technology companies.

32. For the LGPS, the stated ambition is to target a 10% allocation to growth equity and venture capital. There is no explicit stipulation that these investments must be UK-based, although significant inference to this is ultimately made throughout the consultation.

33. It was subsequently clarified by Government ministers that it is possible that a fund may be able to legitimately claim that an investment in UK-based private equity contributes to both the ambitions for LGPS investment in private equity, as well as the levelling up requirements.

34. The Fund currently targets 7.5% in Private Equity (PE) and the majority of this is split between LGPS Central and Adams Street Partners. Of the £425m invested in PE, £30m (7%) is currently invested in the UK, this compares favourably to the UK share in the MSCI world index 4%.

35. While it is recognised PE can provide attractive returns, this must sit alongside other asset classes which on a risk adjusted basis may look as attractive (for example, certain classes of infrastructure).

36. As stressed at the Local Pension Committee meeting in September 2023 the Fund is fundamentally against Government prescribed allocation decisions. Ultimately it is for funds to agree their risk appetite with advice from their respective investment advisors and actuary. Funds must manage their liquidity levels, and while PE is often focused on high-growth companies these are also far riskier, especially in regard to venture capital, and have a higher management cost. Funds and pools could end up bidding up the price for a limited pool of UK based PE opportunities to the detriment of future returns.

<u>Improving the Provision of Investment Consultancy Services to the LGPS</u>

37. The essence of the Government's proposal is to clarify that all LGPS funds would be formally required to set objectives in relation to the Competition and Markets Authority's (CMA) Investment Consultancy and Fiduciary Management Market Investigation Order 2019 (the Order) for investment consultants.

38. The Fund already sets its investment advisor strategic objectives in line with the CMA which are presented to the Local Pension Committee annually so supported the proposal. The Fund questioned the continued exclusion of LGPS pools given the Government suggested elsewhere within the consultation that pools may be able to advise funds on strategic investment decisions.

39. The Fund has further requested that the Government provide guidance on the position of non-FCA regulated advisors and whether they can advise committees and what they can and cannot provide advice on, for example, investment matters, product selection and manager advice.

<u>Updating the LGPS Definition of Investments</u>

40. The Government proposes to make a technical change to the definition of investments within LGPS regulations, adding the word "partnership" to their definition of unquoted securities investments. The response supported this change.

Local Pension Committee Comments

41. The Director of Corporate Resources, in consultation with the Chairman of the Local Pension Committee formulated a response that took into account the above points, and comments from the Committee. These include:

i. The Committee emphasised the importance of maintaining local control over investment decisions and expressed opposition to prescribed asset allocation decisions, citing the fiduciary duty of the Local Pension Committee and Fund.

ii. The Committee acknowledged that the Fund's passive equity investment with LGIM was initially agreed upon as part of the 'Seven Shires' agreement which was cost-effective for the Fund. They expressed concern about transitioning these assets merely as a procedural formality if it led to additional management and transition costs, as well as increased risk.

iii. Recognition that different funds had varying requirements, demands and objectives and that the Fund would continue to work with LGPS Central.

iv. The Committee called for more data to support the objectives of the Government's consultation. This includes evidence related to efficiencies achieved through pool scaling, and how the Fund could contribute to levelling up goals.

v. The Committee noted that 21% of the Fund's investments are in the UK. It was recognised that these investments could potentially contribute to levelling up ambitions in some form or another, given their wide range of missions.

Next Steps

42. The consultation has now closed, the Fund will await further detail on developments that arise from the consultation. The Fund will continue discussions with LGPS Central and partner funds regarding further collaboration through 'moving pooling forward' discussions.

Resource Implications

43. The pooling consultation will look to set the direction for the future structure for LGPS funds. It notes while pooling has delivered substantial benefits so far, progress needs to accelerate to deliver, and government stands ready to take further action if needed. This may result in a smaller number of pools in excess of £50bn (underlying pooled assets from Local Authorities) to gain benefits of scale, and/or expecting funds to accelerate the transfer of assets. The Fund will await the outcome of the consultation for further information on

timescales, approach, expectations for cost savings, and increased reporting requirements which may impact Fund resources.

Recommendation

44. That the report be noted.

Equality Implications

45. There are no equality implications arising from the recommendations in this report.

Human Rights Implications

46. . There are no human rights implications arising from this report.

Background Papers

11 July 2023 Local Government Pension Scheme (England and Wales): Next steps on investments
https://www.gov.uk/government/consultations/local-government-pension-scheme-england-and-wales-next-steps-on-investments/local-government-pension-scheme-england-and-wales-next-steps-on-investments

8 September 2023 Local Pension Committee Pooling Consultation: Next Steps on Investment and LGPS Central Meetings Update (Agenda Item 9)
https://politics.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=7204&Ver=4

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