Leicestershire County Council

LOCAL PENSION COMMITTEE – 6 SEPTEMBER 2024

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

LOCAL GOVERNMENT PENSION SCHEME - CURRENT DEVELOPMENTS

Purpose of the Report

1. The purpose of this report is to provide an update on current developments across the Local Government Pension Scheme (LGPS) following the 2024 General Election.

Policy Framework and Previous Decisions

2. In recognition of the uncertainty regarding the impact of potential changes to the LGPS, the Fund's Risk Register includes a risk (risk 19) related to proposed changes to LGPS regulations and guidance that may require changes to the Fund's investment, pooling and governance processes.

3. This risk is managed through monitoring proposed changes, responding to relevant consultations, and working closely with the Fund's investment advisors, LGPS Central and partner funds. The Local Pension Committee are kept updated on matters as they progress.

Background

4. Leicestershire County Council Pension Fund, along with seven other partner funds, is a member of LGPS Central (Central). Central was established in 2017 to address Government requirements for LGPS funds to pool investments. Its goals include achieving economies of scale, robust governance, cost reduction, excellent value for money, and enhanced capacity and capability for investments.

5. The previous Government consulted on "Next Steps on Investments" in 2023, following which the Committee supported a proposed response on 8 September 2023. The previous Government subsequently published the consultation

outcome on 22 November 2023 and largely reconfirmed the intention to set out requirements and expectations in relation to pooling, levelling up, investment in private equity and training. Throughout this process it was understood there was cross-party support and therefore it was likely the vision set out would continue with any new Government.

Current Developments

6. On 20 July 2024 the new Chancellor set out action that would be taken to "unleash the full investment might of the £360 billion Local Government Pension Scheme to make it an engine for UK growth", and that a review would "look at how to unlock the investment potential of the £360 billion Local Government Pensions Scheme, which manages the savings of those working to deliver our vital local services, as well as how to tackle the £2billion that is being spent on fees."

7. A Terms of Reference for phase one of the Pensions Review was subsequently published on 16 August 2024, attached as Appendix A to this report. This sets out that the Government expects to consult widely as the review secretariat develops its analysis and policy options.

8. Below sets out an overview of potential changes, highlighting areas from the new Government's manifesto and announcements, as well as other current issues carried over from the previous administration.

Pooling and Consolidation

9. A letter was circulated to all LGPS funds on 15 May 2024 by the Local Government Minister at the time, requesting funds respond to a number of questions related to the completion of pension asset pooling by the March 2025 deadline, as well as to how funds ensure that they are run efficiently, with appropriate governance structures in place. While the request was superseded by the General Election, officers, alongside many other LGPS funds have responded to assist with briefing new ministers' post-election given cross-party support. The Fund's response is attached at Appendix B.

10. On the 20 July 2024 the new Chancellor announced:

"The Local Government Pension Scheme (LGPS) in England and Wales is the seventh largest pension fund in the world, managing £360 billion worth of assets. Its value comes from the hard work and dedication of 6.6million people in our public sector, mostly low-paid women, working to deliver our vital local services. Pooling this money would enable the funds to invest in a wider range of UK assets and the government will consider legislating to mandate pooling if insufficient progress is made by March 2025."

11. It has not yet been clarified what could be considered insufficient progress. However, the previous Government set a potential deadline of 31 March 2025 for the transition of listed assets from funds to pools. The Fund's pooling position as of 31 March 2024 is included within the draft Annual Report and Accounts set out elsewhere on today's agenda.

12. The "not pooled" assets include the £1.064billion (16.8% of total fund) of assets that relate to the Fund's collectively procured Legal and General Investment Management (LGIM) passive equity investments. The contract with LGIM was procured together by seven local authorities prior to the commencement of pooling. The Fund sees this low-cost passive investment as essentially pooled. Adding this to the 40% of 'pooled' value equates to 57% of total fund assets being classified as 'pooled'.

13. The Fund has requested that Central bring forward proposals on how best to manage these assets in future. For example, whether it remains appropriate for the Fund to continue to manage these assets, whether Central should take on an advisory role or whether they should be reprocured.

14. The Fund's position of assets pooled should increase by March 2025 given circa £400million of current commitments and an additional £280million of commitments to be made once satisfactory private credit vintages are raised during the second half of 2024 from previous Investment Sub-Committee decisions. The Fund expects pooled funds to increase gradually from the current circa 40% to 54% by 31 March 2028. As previously highlighted the Fund also has 16% invested via the collectively procured LGIM and adding this to the 54% of under pool management funds means the Fund could be around 70% pooled by 31 March 2028.

15. On 7 August 2024 the Chancellor met with Canadian retirement funds and stated that she wants to see "schemes learn lessons from the Canadian model and fire up the UK economy, which would deliver better returns for savers and unlock billions of pounds of investment." Features of Canadian funds include scale, a proportion of in-house management, and diversified assets which tend to focus more on private markets (a reported 48% allocation on average) than listed equity as well as a focus on long-term value creation.

16. As with any proposed change to the LGPS there will be arguments for and against any changes to the current status quo. In terms of arguments for further

consolidation from an LGPS perspective this could lead to greater economies of scale and fee savings if managed appropriately. These are benefits that have already begun to be achieved to date through Central. From the Government's perspective as set out in the Terms of Reference of the Pensions Review, it may also offer an opportunity for "encouraging further pension investment into UK assets to boost growth across the country."

17. In terms of private markets and private equity (PE), the Fund itself already has a higher allocation to these than a lot of other LGPS Funds, but certainly not to the extent of the Canadian funds. Funds must manage their liquidity levels, and while PE is often focused on high-growth companies these are also far riskier, especially regarding venture capital, and have higher management costs. Ultimately the Fund must also manage its fiduciary duty to employers and scheme members. In many cases this will be supportive of Governments ambitions, however, the Fund cannot prioritise these ambitions to the detriment of the scheme and its members.

18. It is also worth noting that many LGPS funds and investment managers have expressed concerns as part of previous consultations that there are other barriers related to execution, regulatory risks and other issues. Any merger could remove responsibility from the local authority depending on the approach taken and may be time-consuming and costly, especially where previously consolidated assets need to be transitioned further.

Fees

19. The proposed review also sets out how it would look to "cut down on fragmentation and waste in the LGPS, which spends around £2 billion each year on fees and costs and is split across 87 funds – an increase in fees of 70% since 2017, the Review will also consider the benefits of further consolidation." This statement includes not only the annual management fees but also transaction costs and performance fees.

20. The increase in the monetary value of fees is not surprising, given most LGPS Funds assets under management (AUM) have grown over this period and management fees are paid usually as a percentage of AUM.

21. A secondary reason for increasing management fees is the general direction of LGPS funds to increasing investments in private markets (such as infrastructure, natural capital, property and private credit) which are more management time intensive compared to traditional listed equity investments and as such

management fees are usually much higher. In addition, moving to investing into private markets can attract one off transaction fees (think of direct property investments where stamp duty is payable in the UK) and performance fees which are usually not payable on asset classes such as passive listed equity. As funds move towards private markets it is expected to add transaction and performance fees. Performance fees, however, would only be paid once the agreed return is achieved and as such are paid out of gains the funds would have experienced.

22. The Fund's yearly investment management costs are set out below (£million). The total investment management costs rose from £37.4m in 2019/20 to £50.9m in 2023/24, an increase of 36%. Stripping out the performance and transaction fees leaves underlying management fees which are payable regardless of investment performance or underlying trading of the funds.

23. Investment management fees rose from £23.7m to £28.3m, an increase of 19% over the 5 years to 31 March 2024. This is within the backdrop of a 48% increase in assets under management and a 4% increase in assets invested in private markets. Investment management fees as a percentage of assets under management (AUM), however, have reduced over the time frame below.

Year ending 31 March	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**Change**
Listed Equity	1,892	1,681	2,329	2,572	2,507	2,697	43%
Private Markets	1,342	1,493	1,491	1,734	1,895	2,056	53%
Other	1,060	970	1,330	1,455	1,308	1,602	51%
Total AUM	**4,294**	**4,144**	**5,150**	**5,761**	**5,709**	**6,355**	**48%**
% Listed equity	44%	41%	45%	45%	44%	42%	-4%
% Private markets	31%	36%	29%	30%	33%	32%	**4%**
% other	25%	23%	26%	25%	23%	25%	2%
Inv mgt fees £m	23.7	24.6	23.3	23.9	24.5	28.3	**19%**

24. The Fund increased its allocation to private markets by 4% from 31 March 2019 to 31 March 2024 and is forecast to increase further as uncalled commitments are drawn by the investment manager. The Fund's allocation to private markets as at 31 March 2024 is 32% of all assets under management and will increase towards 40% over the coming years based on the current strategy. This is above the LGPS average of 20% but below a reported 48% average for the Canadian 'Maple 8' funds.

UK Investment (formerly Levelling Up)

25. As previously reported to the Committee the previous Government consulted on a requirement that the LGPS invest up to 5% in levelling up ambitions across the UK. While the branding ‘levelling up’ has been removed, the new Government has set out their intention to increase investment from pension funds in UK market to boost growth across the country.

26. The Fund’s draft Annual Report is appended elsewhere on today’s agenda and sets out the Fund’s UK exposure in line with the revised annual report guidance. The Fund has c12% of the total assets invested in the UK asset classes listed below.

£million asset values as at 31 March 2024	**Pooled**	**Under pool management**	**Not pooled**	**Total**
UK listed equities	75	15	162	253
UK government bonds	46	98	253	396
UK infrastructure	25		56	81
UK private equity	1		34	35
Total	146	113	505	764

27. The previous Government had proposed that funds publish a “Levelling Up Plan” that funds would need to report annually against. The Fund’s UK exposures remain higher than the relevant market benchmark, and as previously reported to Committee it was possible the Fund already exceeded the 5% depending on how ‘levelling up’ ambitions and asset classes were defined.

28. The previous Government had said it would provide direction on these ‘levelling up’ plans through guidance on investment strategy statements and pooling. The Fund will need to await guidance from the new Government on how this may be progressed.

Other Areas

LGPS Good Governance project

29. The LGPS Scheme Advisory Board was asked to examine the effectiveness of LGPS governance models and consider enhancements to further strengthen governance. A final report was produced in February 2021. In September 2022

the Government at the time confirmed that ministers had considered the action plan alongside the report and agreed to take forward the proposals.

30. Funds continue to await final confirmation of the proposals, and it is unclear whether the new Government will require a fresh look at the proposals, and therefore may provide further delay. In the meantime, the Fund has been acting in line with the Good Governance project in its current form recognising best practice.

Climate Change Reporting and Transition Plans

31. In 2022 the previous Government consulted on extending Taskforce for Climate related Financial Disclosures (TCFD) requirements to the LGPS, to assess, manage and report on climate-related risks in line with the TCFD recommendations. The Fund has reported against these requirements since 2019 and provided its latest report against expected requirements in June 2024.

32. The new Government has set out how they foresee the energy transition as a huge opportunity to generate growth, tackle the cost-of-living crisis and make Britain energy independent. This was also set out within the new Government's manifesto that states pension funds will be required "to develop and implement credible transition plans that align with the 1.5°C goal of the Paris Agreement."

33. In essence it would require funds to set out a transition plan to reach net zero by 2050, and this is in line with the Fund's own net zero ambition. As set out in the Fund's Net Zero Climate Strategy it is important that the Fund supports real-world emissions reductions, and not just 'transition' its assets alone. Ultimately climate risks will, to one extent or another, affect all asset classes, all sectors, and all regions, so the Fund must manage this risk in line with its fiduciary duty.

34. The Fund will continue to monitor guidance on this area and the updated Net Zero Investment Framework by the Institutional Investors Group on Climate Change will be considered as part of the Net Zero Climate Strategy review during 2025 and 2026.

Fiduciary Duties and Climate Change

35. As was presented by the Head of Law and Deputy Monitoring Officer to the Committee and Local Pension Board members at a joint training session in May 2024, a report had been commissioned by the previous government, which was subsequently published on 6 February 2024 by the Financial Markets Law Committee (FMLC). The paper was intended to provide a general explanation of the legal position and the uncertainties and difficulties that exist with relation to

decision marking in the context of sustainability and the subject of climate change.

36. The FMLC paper confirmed that schemes should take into account financially material environmental, social and governance factors. What these factors are, and whether or not they are financially material to a particular investment, is a matter for the trustees (for the LGPS this will be Local Pension Committee members) to judge, based on appropriate advice.

37. A one-off evidence session was then held by the Work and Pensions Committee on the 21 February 2024 on how climate risk is considered and whether changes to fiduciary duties are needed. Subsequently roundtables were set up for May and June, however, these were superseded by the 2024 General Election.

38. Officers will continue to monitor any developments and guidance, however ultimately the report seems to align with the Fund's current approach in taking into account sustainability and climate change as part of decision making.

Economic Activity of Public Bodies

39. The 'Impact on Economic Affairs of Public Bodies (Overseas Matters) Bill' also known as the 'Boycott, Divestment and Sanction Bill' intended to prevent "public bodies when making decisions about procurement and investment from considering a country or territory of origin or other territorial considerations in a way that indicates political or moral disapproval of a foreign state". Neither the LGA nor SAB were aware of any funds making such decisions which would cause rise to this specific bill.

40. Following the dissolution of parliament on 30 May 2024, the bill fell as it had not proceeded through all stages. It remains to be seen if there is any appetite for such a bill in future within the new Government, however, it seems unlikely.

41. The Fund's approach to these matters is set out within the Investment Strategy Statement that "the Fund does not exclude investments to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government."

Review of LGPS 2022 fund valuations

42. On the 14 August the Government Actuary's Department (GAD) published an analysis of the 2022 actuarial valuations of the funds in the LGPS. This analysis

examines whether the actuarial fund valuations have achieved the following aims: compliance, consistency, solvency and long-term cost efficiency.

43. The findings have set out that fund valuations are compliant with the relevant regulations, that the valuation information has been presented in a consistent way across funds, and notes the significant progress made by funds and actuarial advisors in the presentation of climate risk analysis as part of the actuarial valuation process. The improvement in the funding position of the fund has reduced immediate solvency concerns, however, recognises risks remain which are important for funds to consider.

44. Leicestershire County Council Pension Fund's reported funding level in 2022 was 105%. On the analysis from GAD's standardised basis this increased to 116%, with 90% of other funds also seeing increases using GAD's estimates.

45. GAD ranks funds on a number of measures. Leicestershire's rankings for long term cost efficiency measures, are set out below. These show the Fund's positive position in relation to peers:

    a. The required investment return rates to achieve full funding in 20 years' time on the standardized best estimate basis - 11 of 86.
    b. The required investment return rates as calculated in required return, compared with the Fund's expected best estimate of future returns assuming current asset mix is maintained – 7 out of 86.

46. Analysis by GAD shows the Fund is rated 'green' meaning they have found "no material issues that may contribute to a recommendation for remedial action in order to ensure long-term cost efficiency" with one exception.

47. The remaining metric related to asset shock, where a white flag has been allocated. This flag considers what may happen if there is a sustained reduction in the value of return seeking assets for tax raising employers. GAD model the additional contributions that would be required by tax raising employers to meet any emerging deficit. Funds with a high level of return seeking assets are more exposed to asset shocks and more likely to trigger this flag. GAD defines a white flag as an "advisory flag that highlights a general issue but one which does not require an action in isolation. It may have been an amber flag if we had broader concerns". Four other LGPS funds had a white flag raised for this metric, the LCCPF's higher level of return seeking assets means that there is a higher likelihood of this metric returning an unfavourable outcome based on quantitative measures alone. The analysis doesn't distinguish between the types of return seeking assets which have differing risk characteristics, listed equity versus core infrastructure for example.

48. Officers do not consider this a concern that needs to be addressed at this point, and it is noted that while this focuses on concerns over return seeking assets, in

2022/23 when markets were rocked by global interest rate increases, traditional protection assets saw instability and were repriced just as sharply as traditional risk assets and so may not necessarily be the most conclusive metric for asset shock risk. In any case, the Fund's Investment Strategy is reviewed each year alongside allocations to each asset class. During 2024 the Fund has commissioned Hymans Robertson to complete a protection assets review where it was concluded the current allocation to protection assets was suitable and no increase or decrease to the asset within this area was necessary at this point.

Resource Implications

49. The current announcements seem to set the direction for a potential restructure for LGPS funds. The Director of Corporate Resources notes that while pooling has delivered substantial benefits so far, progress needs to accelerate to deliver, and the government stands ready to take further action if needed. This may result in a smaller number of pools gaining benefits of scale, and/or expecting funds to accelerate the transfer of assets. Officers will await any future review and consider how this may impact Fund resources.

Next Steps

50. The government has set out that they will look to report the initial findings of the first stage of the pensions review later this year, and ahead of the introduction of the Pension Schemes Bill.

51. Officers will await any further information on the review, and any other topics within this report and consider next steps and update the Committee as necessary.

Recommendations

52. It is recommended that Committee note the report.

Background Papers

8 September 2023 – Local Pension Committee - Pooling Consultation: Next Steps on Investment
https://politics.leics.gov.uk/ieListDocuments.aspx?CId=740&MId=7204&Ver=4

19 June 2024 – Local Pension Committee – Responsible Investing Update
https://democracy.leics.gov.uk/ieListDocuments.aspx?MId=7540

Appendices

Appendix A: Phase 1 Pensions Review Terms of Reference
Appendix B: Leicestershire County Council Pension Fund Response to DHLUC

Equality Implications

The Fund takes into account issues around Equality and Human Rights as part of its whole approach to responsible investment and environmental, social and governance factors in all investment decisions. The Fund will not appoint any manager unless they can show evidence that responsible investment considerations are an integral part of their decision-making processes. This is further supported by the Fund's approach to stewardship and voting through voting, and its approach to engagement in support of a fair and just transition to net zero.

Human Rights Implications

There are no Human Rights implications arising from this report.

Environmental Implications

The Net Zero Climate Strategy outlines the high-level approach the Fund is taking to its view on Climate Risk. This will align with the Fund's Responsible Investment approach as set out in the Principles for Responsible Investment. As set out above the Fund is committed to supporting a fair and just transition to net-zero. The Fund is set to review the NZCS over 2025/26 and will consider any new requirements as part of that.

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