Leicestershire County Council

LOCAL PENSION COMMITTEE – 29 NOVEMBER 2024

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

MANSION HOUSE PROPOSALS

Purpose of the Report

1. The purpose of this report is to:

    a. Inform the Local Pension Committee (LPC) of a consultation paper issued by the Ministry of Housing, Communities and Local Government titled "Local Government Pension Scheme (LGPS): Fit for the future" and to seek the Committee's views on the key themes;

    b. Seek approval for the Director of Corporate Resources to be authorised to respond to the consultation by the required deadline of 16 January 2025.

Policy Framework and Previous Decisions

2. On the 20 July 2024 the Chancellor launched Phase One of the Pensions Review. The government then issued a call for evidence on the 4 September which closed on the 25 September. Leicestershire County Council Pension Fund's (the Fund) response to this is attached. The government published the findings of Phase One of the Review on the 14 November that is available here.

Background

3. The focus of the Pensions Review for the LGPS was to look at how tackling fragmentation and inefficiency of funds can unlock the investment potential of the scheme.

Mansion House Proposals

4. On the 14 November the Chancellor announced the fit for the future consultation on significant proposals related to the LGPS. Given timescales involved it is proposed the response be delegated to the Director of Corporate Resources in consultation with the Chairman of the LPC ahead of the 16 January 2025 deadline.

5. At a high level these proposals can be seen positively, in that they look to further existing ambitions and the progress achieved to date through pooling. Any

consultation response will look to build on these positives whilst reaffirming the foremost priority of the Fund to achieve appropriate risk adjusted investment returns in line with its fiduciary duty to employers and scheme members. Early considerations and thoughts from the perspective of the Fund are set out from paragraph 14 onwards.

6. The report below sets out the key themes and areas of the consultation that the government are inviting view on where they differ from the Fund's and LGPS Central's (Central) existing functions.

LGPS pooling

7. As part of the consultation the government have highlighted the benefits to pooling thus far, such as lower fees, enhanced investment opportunities and improved efficiencies and resilience. It is the government's intention that these proposed measures build on these strengths and allow for funds and pools to operate with clarity and efficiency over the long term. Key themes of the proposals are as follows:

- <u>A requirement on Administering Authorities (AAs) to fully delegate the implementation of their investment strategy to their pool.</u> In practice this would mean the Fund would retain its annual consideration of the strategic asset allocation (SAA), return objectives, risk tolerances, constraints and limitations and the high level approaches to local investment and responsible investment. This will likely be limited to a broad strategic level and limited to broad asset class or general investment themes. The implementation of this approach, such as adjustments to the asset mix, geographic allocation, appointments of managers and choice of investment opportunity would be largely left to Central.

- <u>A requirement on AAs to take their principal investment advice from the pool.</u> Currently investment and SAA advice is received from Hymans Robertson, the Fund's Investment Advisor. As part of this advice the Fund engages with Central to aid with the potential pipeline of investment projects that Central prepare. This proposal would result in pools advising on the investment strategy, and the implementation of it.

- <u>A requirement for AAs to transfer legacy assets to the management of their pool by 31 March 2026</u>. There are different approaches that can be taken for transition of legacy assets, some more resource and cost intensive than others. This may include the transition of illiquid assets to Central for management responsibility. In such a case the decision on whether to hold these to maturity, rollover long-term contracts or invest elsewhere would rest with Central. The consultation also asks for views on what capacity and expertise the pools would need to develop to take on management of legacy assets to this end.

8. The Summary Valuation report, elsewhere on this agenda, sets out more details with regards to the Fund's legacy assets.

Local Investment

9. Government's proposals set out that growth is their number one mission. Through this it is recognised that the LGPS already invests approximately 30% of its assets in the UK. The government believes that the LGPS can make a distinctive contribution to UK and local growth, building on its local role and networks, through increasing its long-term investment in local communities.

10. To this end the government have proposed the following within the consultation:

- <u>Funds to set out approach to local investment with regard to local growth plans and local economic priorities in setting their investment strategy, and work with local authorities</u>. This proposal defines local investment to include investments local to any of a pool's partner AAs, or investment in their region. Government propose that AAs set a high-level objective on local investment within the Investment Strategy Statement, including a target range for local investment as a proportion of the fund. It is unclear at this point whether for the Fund this would mean setting a target for Leicester, Leicestershire and Rutland target, or a wider pool area target.

- To undertake the proposal the government are suggesting a requirement for the pools to develop the capability to carry out due diligence on local investment opportunities and decide whether to invest.

Governance of funds and pools

11. The final key area relates to the governance of funds and pools. The government is largely proposing bringing in recommendations from the Scheme Advisory Board (SAB) Good Governance Review. These are recommendations which the Fund has followed for a number of years, including training and conflicts of interest. These areas will need to be reviewed in line with any final guidance.

12. Further proposals include:

- <u>A requirement for AAs to participate in a biennial independent governance review</u> and, if applicable, produce an improvement plan to address any issues identified. This will be led by the SAB along a similar line of the Local Government Association peer challenge service.

- A requirement for pension committees to include an independent person who is a pension professional, whether as a voting member or as an adviser. The government have recognised there would be additional cost but that it would provide an increased knowledge base for committees.

- A requirement for pool boards to include one or two representatives of shareholder AAs, such as the Chair of the Shareholder Committee or equivalent. As well as a question asking for views on the best way to ensure that members' views and interests are considered by the pools.

- A requirement for pools to publish asset performance and transaction costs. It will be important that performance reflects risk taken and that AAs are able to hold pools to account in the event of poor performance.

- That funds appoint a senior LGPS officer.

13. While these proposals do not mandate mergers, the potential for collaboration between partner funds in the same pools on issues such as administration, training, councillors and pension board members, may be an indication of what could come next.

Initial Considerations

14. Officers have begun to digest the information contained within the consultation and supporting documentation that had been published as part of the development of a Fund response. It is evident that the consultation sets out a direction of travel to conclude what was started in 2015 with the introduction of pooling. This approach has held cross-party support over the years and is unlikely to materially shift.

15. The Fund is supportive of pooling and appreciates the range of investments, simplification and cost benefits it offers the Fund to the benefit of employers. To date the Fund is over 40% pooled with another 18% collectively procured passive equity assets.

16. At a high level there are plenty of positives to be taken in continuing the Fund's trajectory towards pooling which will continue the good practice already achieved. What will be vital in any response is how best these changes are enacted by the government in appropriately managing changes so as not to lose sight of the schemes primary purpose. These considerations are broadly set out below.

Fiduciary Duty

17. Current proposals may restrict AAs ability to hold pools accountable, as assets will flow to pools regardless of their performance which presents difficulty for AAs as fiduciary stewards. Given AAs own the pooling companies, traditional commercial sanctions will be less effective, as compensation would ultimately come from the pool AAs themselves. It is crucial for the government to consider mechanisms that promote effective pooling while ensuring that risk taking remains within acceptable bounds, as any shortfall will ultimately impact the employers within the scheme.

18. To address these concerns the AAs fiduciary duty could be extended to the asset pools. As well as by requiring appropriate checks and balances with AAs to ensure SAA implementation fits with different scheme requirements, and how additional costs may be managed or addressed.

Conflict of Interests

19. The consultation suggests that pools will begin to primarily advise on setting and implementing SAA. This represents a significant shift from existing processes and may introduce a potential conflict which may lead to implementation of sub-optimal strategies.

20. It is recognised that the current format of each AA procuring its own investment advisor can result in fragmentation and challenges for pools in developing a unified strategic view. However, as previous Fund consultation responses have set out there may be other opportunities in the short-term to instead procure a joint investment advisor across all partner funds within a pool. This might allow for independence, expertise and knowledge of the market, together with a more unified approach to investment, and resource efficiencies, while being able to hold pools to account in support of AAs fiduciary duty. Consideration will also need to be given to existing contractual arrangements that the Funds already have in place.

21. The proposals suggest some of these conflicts may be managed through AA representation on pool boards, however given requirements placed upon company boards by the Companies Act it is unlikely such a recommendation would be able to protect AAs from this risk, given boards must legally act in the interests of the company.

Capacity

22. These proposals represent a significant increase to the requirements placed on pools. Pools now potentially have 16 months to take on a large increase in assets, including the transfer of legacy illiquid holdings and build out new capabilities in the complex areas of investment advice and local investment.

23. To date while the Fund has made commitments to Central, time needed to create appropriate mandates and deploy capital has left the Fund with significant cash holdings. This could be resolved through pools being able to invest in non-pooled products to avoid unnecessary cash holdings, while in the process of developing mandates, or where external management would be of greater benefit due to expertise and resourcing for example.

24. Given the number of legacy assets across AAs careful consideration will need to be given to increased capacity and resourcing for the pools which may not be as cost effective as funds managing legacy assets down over time, as well as who will be responsible for any transition costs. Conversely it is recognised this approach makes it a lot easier for the pools to build products with discretion on implementing the SAA, and visibility of returning capital. This may present new potential conflicts for the pool if provided discretion to sell out of product early, which may result in a additional costs for a fund. These potential conflicts could be managed with an appropriate governance approach.

<u>Local Investment</u>

25. While the consultation does not suggest it will mandate how funds or pools should invest, the Pensions Minister has stated that if these reforms do not produce a significant increase in the share of assets committed to domestic investment then the government could start to compel British funds to invest a certain proportion of their money in the UK.

26. As LPC has recognised at prior meetings there are plenty of challenges around direction of local investment. Key concerns remain issues around diversification, availability of opportunities and the potential for political risks if not managed carefully. A broader UK-wide definition might mitigate these concerns, especially given the significant assets already invested in the UK. This would further reflect the approach taken by the Canadian pension fund schemes which have been highlighted as best practice.

27. If pools are delegated implementation of local investment considerations, then this may reduce these conflicts. However, as with any investment, especially where geographically limited, the Fund will need assurance that the risk and returns are no less than what would otherwise have been targeted. This would be supported though pools having the same fiduciary duty as AAs.

28. Careful consideration would need to be given to resourcing requirements at pools to undertake these opportunities. Opportunities at a local level may be relatively small for the scale of the pool, and it may be more effective to outsource these deals to managers with local expertise.

Governance

29. The Fund has supported improved governance recommendations for a number of years. However, considering these proposals alongside the other consultation areas seems to present some conflict in that requirements are increasing at a time where AA responsibilities related to investments are being taken on by pools. It is important that any new governance responsibilities are appropriate and proportionate to scheme requirements, for example an independent governance review may be more appropriate matching with the Fund's triennial valuation process, or a longer time period depending on initial good performance.

Collaboration and Consolidation

30. The consultation further looks at what scope there is to increase collaboration between pools for the sharing of specialisms. This would be welcomed given benefits it may have where pools are unable to achieve critical mass for example with regards to niche investments. Further collaboration may also let itself to alignment of net zero approaches including issues such as engagement and voting where underlying funds are more unified in approaches.

31. At this point in time the government are not suggesting creation of one 'megafund'. Instead, proposals focus on existing pools going further faster, and encourage funds to increase collaboration where opportunities exist. While not directly referenced within the consultation this may spur discussions of pool mergers where pools are not already Financial Conduct Association (FCA) authorised, given the March 2026 deadline for pooling all assets. While Central is FCA authorised, any response will need to appropriately address how any potential mergers, for example into Central, might impact existing governance and investment structures, and extra costs.

Resource Implications

32. It is noted that while pooling has delivered substantial benefits so far, progress has been slower than originally envisaged. Government have strongly indicated that they will take further action if needed to accelerate the transfer of assets and responsibilities to pools.

33. Officers will address potential resourcing considerations and changes to the operation of the Pension Committee and Board within the consultation response and await its outcome to best consider how this may impact Fund resources.

Next Steps

34. These themes are covered by 30 questions available here. The Fund has until the 16 January 2025 to respond. It is proposed that the Committee delegate the response to the Director of Corporate Resources in consultation with the

Chairman of the LPC. This will be reported back to Committee on the 31 January 2025.

35. Any outcomes will be communicated to the LPC and Pension Board when available. Early commentary seems to suggest the Pension Scheme Bill will follow in 2025, with regulations following in 2026.

Recommendation

36. The Committee is recommended to:
    a) Note the government consultation titled 'Local Government Pension Scheme – Fit for the Future' and comment on the main themes.

    b) Authorise the Director of Corporate Resources, following consultation with the Chairman of the LPC, to prepare the detailed response to the consultation on behalf of the Fund taking account of any comments made by the Committee, and to submit this to Government by the deadline of 16 January 2025.

Equality Implications

37. The government had undertaken an initial equality impact assessment and do not believe the proposals affect any particular groups with protected characteristics adversely as there will be no change to member contributions or benefits as a result. Government state there may be an indirect benefit to protected groups who live in disadvantaged areas which benefit from local investments.

Human Rights Implications

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

Environmental Implications

39. The Fund has agreed a Net Zero Climate Strategy (NZCS). This outlines the high-level approach the Fund is taking to its view on Climate Risk. The consultation proposes that funds retain responsibility for setting a high-level investment strategy including environmental, social and governance matters and responsible investment. It is likely the Fund will need to continue to work closely with Central and Partner Funds on these matters.

Appendix

Call for Evidence response.

Background Papers

1 December 2023 – Local Pension Committee – Pooling Consultation: Next Steps on Investment and LGPS Central Meetings Update

24 May 2021 – Local Pension Board – Good Governance Phase 3 – Progress Report

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