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Dear LGF Pensions Team

SPP response to DLUHC consultation: Local Government Pension Scheme (England and Wales): Next steps on investments

We welcome the opportunity to respond to this consultation.

Executive Summary

In the following response, we have only answered those questions which are relevant to SPP members where we have particular views. The members of the SPP advise a wide range of stakeholders, including Administering Authorities, some operators of Pool companies and employers both within the private sector as contractors and third-sector entities such as universities and housing associations. As such, our comments reflect the interests for a wide range of parties who are all interested in the continued success of the LGPS as a whole in delivering pensions.

We are also conscious of the wider context of the Government's Mansion House proposals and, in particular, the promotion of greater investment in the UK by pension funds in both the public and private sectors. SPP has separately responded to the Government on those proposals, but we are taking this opportunity, as this response is addressed to DHLUC, to underline the central question of the fiduciary duties of all pension funds, which is, in the case of the LGPS, to ensure that the statutory power of investment given to Administering Authorities is used to deliver on the obligation to pay the pensions promised to members of the LGPS. The SPP supports the efficient exercise of those powers of investment to deliver better returns for the security of scheme members' benefits and, in so doing, the proper discharge of Administering Authorities' fiduciary duties, but we believe that in many important respects, the consultation document appears to

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ignore (a) the importance of these duties, particularly in the Levelling Up and Private Equity proposals in chapters 3 and 4 and (b) the integration of investment and funding risk management[1].

In summary, we believe that the consultation document's proposals would fundamentally disrupt the good work that has been achieved since 2015 to achieve a balance between administering authorities as the asset owners and the pool operators. We believe the sovereignty of funds as fiduciaries to be paramount; the proposals for levelling up and ambitions for UK-centric private equity detract from that principle for non-pensions purposes.

We are also very concerned that the Government has not been able to justify the proposals through a cost-benefit analysis, which we suggest, particularly in the case of proposed moves of significant passive portfolios to the pools, would demonstrate that the case is not made.

We would welcome the opportunity to discuss any of the comments made in this response to the consultation.

Detailed Response

Chapter 2: Asset pooling in the LGPS

Question 1: Do you consider that there are alternative approaches, opportunities or barriers within LGPS administering authorities' or investment pools' structures that should be considered to support the delivery of excellent value for money and outstanding net performance?

No, we do not believe that there are viable alternatives to the pooling arrangements that have already been established, which could be adopted without both significant and unwarranted extra cost and disruption. From a regulatory point of view, the LGPS Investment Regulations 2016 removed potential barriers to pooling (which were defined by maximum amounts that could be invested in particular legal structures, rather than minimum proportions to be invested in asset classes of investments). It would be a retrograde step to reintroduce quantitative criteria for certain types of investment. This has a bearing on the questions covered by chapters 3 and 4.

Parliament legislated, through the existing terms of Regulation 7(2)(e), for a requirement on authorities to state what their "approach to pooling and the use of shared services" is in their investment strategy statements ("ISS"). Each authority has therefore had to justify its approach to pooling to its own stakeholders in terms of both value for money and net performance (with, we assume, a consideration of the impact of its asset allocation choices on its funding position, which we believe is a central facet of achieving "performance").

As far as alternative "approaches" are concerned, each pooling arrangement has been carefully structured and negotiated between the parties. Disrupting those consensual contractual arrangements, by directing authorities to merge pools to achieve the scale that some have not yet achieved (on which see our response to question 2 below) would have to be achieved either by revised Investment Regulations or by the use of the Secretary of State's powers in Regulation 8. The latter would, in our view, be a very dangerous path for the Government to pursue and would require very careful scrutiny because of the risk of judicial review. This is a recurrent risk that various aspects of the proposals raise.

Because question 1 is predicated on the need to deliver value for money, we are surprised that the consultation document contains no impact assessment of the costs of the proposals.

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[1] We assume that Government does not intend to amend existing guidance on ESG considerations (as set out in the guidance on preparing an investment strategy statement). We note that the consultation document is silent in this respect.

Question 2: Do you agree with the proposal to set a deadline in guidance requiring administering authorities to transition listed assets to their LGPS pool by March 2025?

Listed assets transition

Although, in principle, there should be no general obstacle to transitioning listed assets to a suitable receiving vehicle within an LGPS pool by March 2025, there is a fundamental fiduciary point which each authority would need to satisfy itself before making any required transition. This is that the relevant pool operator should have demonstrated that it provides, in its listed asset solution(s), the following characteristics: value for money, competent management and a history of net returns which are appropriate if not superior to those that can be obtained outside the pool for the relevant investment class and chosen investment strategy. The pool operator should also offer a sufficient opportunity set to address differences in asset allocation and investment risk appetite between the authorities investing in that pool.

We would also draw your attention to the comments made below around the definition of pooled assets for this purpose and, in particular, externally managed passive funds.

There might also be very good reasons why an arbitrary date might be inappropriate for a particular authority to comply with a March 2025 deadline, not least the other demands on authorities in respect of implementing McCloud and preparing for pensions dashboards and with very constrained resources. We therefore recommend that if revised guidance does contain a deadline, authorities are permitted to comply or explain.

Increased scale of pools

We would not argue that the commercial bargaining power of larger institutional investors can achieve better commercial and, indeed, legal terms when buying investments, nor can there be any argument about the potential to build internal management capabilities. However, the evidence points to scale benefits at the mandate rather than the total pool level; larger pools should be able to access lower fees, but only if the mandates they can offer are also larger. Whether such larger investors can have access to a wider opportunity set of investments remains to be seen and would be case-specific. There is also the risk of dis-economies of scale caused by very large institutional investors becoming so large that if they need to change asset allocation they would cause unintended market impacts.

Pooled Assets and Assets Under Pool Management

Paragraph 9 of the consultation attempts to differentiate between "pooled assets" and "assets under pool management", which raises important issues not simply in relation to listed assets (and therefore to the timetable for transition of those assets) but also for private markets. We address the implications for private markets below.

However, SPP is particularly concerned at the proposal to classify in particular passively managed assets as being not “properly” pooled simply because of the legal model used to hold them (i.e. via insurance contracts, a legal model that has served the pensions industry well over several decades).

In proposing this distinction, the Government has created an artificial rationale for driving further pooling with the suggestion that there is some inefficiency because pool operators merely have management or oversight of such assets without ownership when there will always be a need for pools to be able to seek externally managed and owned vehicles on behalf of their owner/investors in order to effectively access expertise and/or scale. This proposition is dangerously simplistic for the following reasons.

First, it is the administering authorities who need, as the asset owners, to have oversight of how their assets are being managed. Pool operators do not have such fiduciary responsibilities, unless they have been given that duty under fiduciary management contracts (and even then that does

not mean that the act of delegation by administering authorities absolves them of their own responsibilities). The majority of the pools have not been set up on this model.

Second, to argue that transferring externally managed passive portfolios to the pools will deliver either lower costs or better returns via presumably lower tracking errors (see paragraph 11) ignores economic reality. The most efficient managers of passive portfolios do so because of their very scale, which enables them to replicate the relevant index with the most accuracy and thus reduce the tracking error which would otherwise be inherent in a sub-scale portfolio. Those managers have already delivered highly competitive LGPS-wide charging structures, achieved without the need to allocate additional capital or infrastructure, both of which would be needed were the pools to have to create passive management capacity. We simply doubt that any more cost can be saved and indeed the proposals would increase costs for the reasons set out below. The operational resource needed to build a new passive manager is also not to be under-estimated, and each pool operator would need rigorous risk management to support such a venture.

Third, even if the pools were to be able to compete with private sector passive managers, the authorities (as the asset owners) would still need to be satisfied that they would be discharging their fiduciary duties appropriately by investing with what would be untested passive pool operators.

Fourth, terminating contractual arrangements with third-party providers, which have been entered into after public procurement exercises, could give rise to termination consequences (as paragraph 13 appears unwillingly to acknowledge).

Fifth and perhaps most important, from an operational perspective, the Government would have created a significant transition risk which is unwarranted and, with a portfolio of £114bn to move to the pools, would cause market impact issues, which we suggest would be so costly to manage that the point of the exercise would be undermined.

Private markets and ownership

Most of the pools that have made progress with private markets pooling have created bespoke new funds using a co-ownership model, such as an ACS or a Limited Partnership. Examples are LGPS Central and Border to Coast PE vehicles and the GLIL infrastructure fund. However, there are instances of authorities who had already invested in pooled funds in asset classes, particularly infrastructure and real estate, which may either be open to other investors and/or which are externally managed (e.g. IFM's flagship global infrastructure fund). These investments would not qualify under Government's proposed "pooled asset" definition despite being "under pooled management". There are, therefore, very good reasons why these assets should not be disinvested and transferred to the pools (as with other directly held assets).

Notwithstanding that the scale of private market investments is significantly less than for passive listed assets, we would reiterate the fundamental points made above in relation to the arbitrary nature of the proposed distinction. To require the transfer of existing illiquid assets, which in most cases carry penalties on early redemption and where transfers are subject to the discretion of the general partner, to being owned by the pool/pool operator, merely, so that they qualify as "pooled assets" (as defined by the Consultation) would involve unwarranted costs and defeat the economic case for pooling.

We, therefore, strongly disagree with this aspect of the recommendations in this part of the consultation document.

Question 3: Should Government revise guidance so as to set out fully how funds and pools should interact, and promote a model of pooling which includes the characteristics described above?

No. The temptation to replace the existing statutory guidance, which contains good and measured approaches to governance, should be resisted. There is no overriding legal reason to promote one model above others (such as the need to preserve limited liability for authorities who choose to undertake commercial activities by the use of a limited liability company[2]), and it is not Government's job to intervene in contractual arrangements which have been entered into in good faith and in compliance with existing statutory guidance.

The Government wisely did not mandate a model for pooling in 2015, and it would be inappropriate to do so now. There is an inconsistency in stating, within the same paragraph (31), that "each model has its own benefits" and simultaneously promoting a pool operator company model ("pools should operate as a single entity"). To justify the promotion of any preferred model would require a full impact assessment to compare the costs of establishment of the various pools, as well as a comparison of the contribution towards the comparative performance of those assets which have been pooled, those under "pool management" and those which remain outside the pools. As pointed out above, for the scale of the ambition outlined in the consultation document, we find it very surprising that no such impact assessment has been provided.

We would also challenge the inference that greater delegation to the pool operators will inevitably lead to greater efficiency and, therefore, (although it is not stated) to higher returns. This proposition (and indeed the proposal to boost the asset bases of the operators by transitioning passively managed assets and other "assets under pool management) rests on an assumption that there is, in fact, a significant degree of untapped internal "management" resource capable of managing these currently externally run portfolios. The reality is that external managers still actually take day-to-day decisions because all of the pools are fund-of-fund structures, and the pool operators largely implement strategic choices such as manager selection, as opposed to individual stock-picking.

The statement in paragraph 25 that "the pool partnerships which have a higher degree of delegation, closer alignment of strategy and larger proportion of assets pooled have the conditions in place to deliver significantly higher savings compared to pools less advanced in their pooling journey" needs to be scrutinised closely. As discussed above, the consultation contains no detailed cost-benefit analysis of its proposals. Having "conditions in place" is not the same as evidencing the delivery of enhanced net performance.

We would also remind the Government that the ultimate funding levels of individual authorities are not necessarily correlated to the extent of pooling. Paragraph 26 acknowledges that certain funds have chosen not to pool a significant part of their assets but have nonetheless "benefited from a wider reduction in fees in the market". Surely that is no bad thing if those authorities are not convinced, in line with their fiduciary duties, that to pool their assets with an under-performing pool operating company would be detrimental to the interests of their members to whom those duties are owed? The proposition that such authorities have missed out on a wider set of opportunities is also questionable. What ultimately matters is the ability to pay pensions from a well-funded scheme.

We comment on each of the proposed characteristics in paragraph 31 below.

- "*Pools should operate as a single entity which acts on behalf of and in the sole interests of the partner funds. For this reason, we do not see inter-pool competition as a desirable progression. This does not preclude the potential for inter-pool collaboration, which is encouraged by government*".

We agree that collaboration is to be encouraged. We also agree that pool operators ought to act in the sole interests of their partner funds where those operators are owned by the relevant authorities. This reflects (in a broad sense) the requirement of the Public Contracts Regulations

[2] See Localism Act 2011, section 4.

2015 (and the proposed Procurement Bill) for companies owned by contracting authorities who benefit from an exemption from public procurement rules (so-called "Teckal" companies). It also broadly reflects the balance of power in the shareholder agreements between those pool operators and their shareholders.

However, such an obligation to act in the sole interest of partner funds can only apply to the pool companies owned by those funds. Contractors and suppliers providing services to the pool cannot be held to the same obligation; for example, the pool operators which have been publicly procured (which are not Teckal companies) cannot be constrained by such objectives (as they have other customers and are not owned by local authorities).

Pool operators, at least in respect of running ACS, must, as a matter of law, exercise all the contractual rights of that ACS on behalf of their investors. As such, the statement that pool operators should act as a "single entity" simply states what the law requires, but only in that context.

- *Pools should be actively advising funds regarding investment decisions, including investment strategies*.

The need for authorities to take "proper advice" on their investment decisions has long been a feature of LGPS regulations. One of the reforms made in the current Investment Regulations was to remove the ability for an officer of an authority to provide such advice (to reduce the scope for conflicts of interest and to enhance governance by requiring that advice to be given by a person qualified and experienced in financial matters).

Many pool operators have the necessary regulatory permission under FSMA to give investment advice and a number have investment advisory agreements in place with their authorities to do so. However, there is a big difference between *allowing* that contractually agreed position to continue and prescribing that pool operators *should* be actively advising. The obstacles to such a change across all pools are: (a) not every pool operator has this mandate, and some do not want it as their business models are not advisory; (b) authorities should be free to purchase advice from whichever source they wish; it is their judgement, not Government's, as to who can provide proper advice, and (c) the conflation of investment advice and investment management, otherwise known as fiduciary management, while an efficient business model embraced by many private sector funds, should again be a matter of choice for authorities and not imposed by Government. On this subject, please see our comments on Chapter 5 and question 13 regarding the CMA Order.

- *Pools should be equipped to implement an investment strategy as instructed by their partner fund. An investment strategy should be interpreted to mean a broad instruction regarding asset classes and level of risk. It should not include an excessive number of classes, or choice of specific assets*.

There is a balance to be struck here between pools providing the vehicles necessary to deliver the investment strategies of their partner funds and partner funds being too specific in the requirements set out in those strategies. Restricting partner funds to only be able to set strategies at a very high asset level (for example, only having one listed global equity fund) may not enable partner funds to adequately implement strategies based on an individual and appropriate assessment of liabilities. On the other hand, partner funds attempting to tie down pools to providing very specific mandates (for example, requiring the industry sector, geographical area and manager style within an asset class) can and will result in smaller mandates and less efficiency.

We agree that all pool operators, whether Teckal companies or commercial providers, should be appropriately resourced. If not, authorities should be free not to use their services in keeping with discharging their fiduciary duties. The inference that authorities may only use their pool operators to implement their investment strategies (for which those authorities are ultimately accountable) suggests, when taken with the "single entity" proposition above, is that authorities must not use

more than one operator. This would again run counter to authorities' fiduciary duty in the event of a failing operator and preclude the cooperation discussed in the consultation, e.g. an LGPS wide infrastructure pooled vehicle.

- *Pools should expect funds to invest via their existing sub-funds where possible. This avoids an unfavourable scenario whereby an excessive number of similar sub-funds undermine the purposes and benefits of pooling*.

As for an "excessive" number of asset classes, it would be helpful if Government could be more specific. We agree that there is a balance to be struck between diversification of investment risk (on which authorities are required to disclose their policy in their ISS) and economies of scale in rationalising the number of asset classes offered by pool operators to authorities. However, one of the reasons why some authorities have been reluctant to transition assets to pool operators has been precisely the narrowness of investment choices offered to them, which have not allowed them to deliver their investment strategies. Operators should listen to their customers, rather than dictate what they think they want.

- *Pool governance structures should be equipped to take quick decisions as opportunities present themselves, within the delegated remit of the fund*.

This statement comes very close to endorsing a model of fiduciary management, which a minority of authorities may be happy to endorse but most will not. We do not disagree that if a pool operator holds itself out as being able to act quickly then the contractual delegation it has should support and not inhibit such actions, but that should be a matter of choice.

Question 4: Should guidance include a requirement for administering authorities to have a training policy for pensions committee members and to report against the policy?

Yes.

Question 5: Do you agree with the proposals regarding reporting? Should there be an additional requirement for funds to report net returns for each asset class against a consistent benchmark, and if so, how should this requirement operate?

We would question the purpose of such changes to reporting as the consultation document does not really explain why such changes are necessary. We reiterate our disagreement with the distinction between "pooled assets" and "assets under pool management". To exclude the latter assets would be inappropriate, especially under the guise of apparently improved reporting. Additional onerous reporting requirements at the time of squeezed resources would be unwelcome.

Question 6: Do you agree with the proposals for the Scheme Annual Report?

Yes.

Chapter 3: LGPS investments and levelling up

Question 7: Do you agree with the proposed definition of levelling up investments?

If by "definition" the Government means only those two elements which are encapsulated in paragraph 62, i.e. a "measurable contribution to one of the levelling up missions set out in the LWUP" and an investment which would "support any local area within the UK", we would have no fundamental objection to such a definition. However, the question masks much more complicated issues. We agree with the statement in paragraph 64 that any inclusion of levelling up must be consistent with a fund's ISS and Funding Strategy Statement ("FSS") because of the need for

authorities to comply with their fiduciary duty towards members of their fund. As such, we would take issue with the proposal in paragraph 65 that there should be a new *requirement* to level up, since there is no problem with the current regulatory framework and the recognition that non-financial factors may be taken into account in investment decision-making (as paragraph 66 correctly states). However, there are a number of fundamental issues associated with the Government's proposals.

1. The first is that Government's objective (as articulated in the Levelling Up and Regeneration Bill) is primarily concerned with non-pensions issues. In other words, to usurp the fiduciary and statutory responsibilities of elected members in relation to the LGPS for an ulterior motive, would create exactly the same potential for judicial review as was established by the Palestine[3] case.

2. Where the consultation talks about "targeted interventions" (paragraph 58), the Government should be mindful of the fact that the Supreme Court clearly stated in Palestine that assets owned by the LGPS authorities were "not public money". We also find it very surprising that paragraph 65 baldly states that "This new requirement *would* not alter the established fiduciary duty of LGPS funds to make investment decisions in order to pay pensions." We disagree; that is clearly the duty but if the exercise of the power of investment would be to invest in better risk-adjusted opportunities, that could be contrary to the duty.

3. Of the 12 so-called "missions", a number appear not to be investible opportunities. These are: "pride in place, living standards, wellbeing, crime and local leadership".[4] If the policy aim in respect of levelling up for the LGPS is in fact really aimed at infrastructure investment, or investments which can be expressed by reference to private markets, then the proposed definition should say so and narrow the field of the so-called missions which are applicable to potentially investable assets. This is consistent with one of the original 2015 Investment Reform Criteria.

4. The comments in paragraphs 61 and 73, by which the Consultation seeks to justify the levelling up case by avoiding the need for "costly deal-by-deal auctions", are naïve (given that this is capital is raised for infrastructure deals so as to get the best value for the tax payer), unless Government is suggesting that such projects must be reserved for LGPS investors. The corollary of that would be the start of a path to the nationalisation of LGPS assets, which in turn would mean that the Government must assume responsibility for the Scheme's liabilities. We assume this is not the intention.

5. The idea that conflicts of interest around local investments can be averted by delegating investment decisions to pool operators strikes us as spurious; surely the problem simply moves to the pool operators (which are, in the Government's preferred model, owned by the authorities)? They must be subject to the same rigour in decision-making as if levelling up decisions were taken at an authority level.

Question 8: Do you agree that funds should be able to invest through their own pool in another pool's investment vehicle?

On a purely fiduciary level, we have no issue with making it clear that authorities should be able to invest via another pooling arrangement if that suits their needs. All investment decisions should be based on a risk-adjusted return basis. However, they should be able to do so directly, not via their own pool operators, as to do so will inevitably lead to additional layering of costs.

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[3] R v Palestine Solidarity Campaign Limited S C 2020

[4] We find it rather strange that the consultation document contained a link to the White Paper, given that the Levelling Up Bill is in its second reading and contains some more precise targets.

There are practical issues which also need to be considered. The first is cost: having not contributed to the establishment cost of another pooling arrangement, a new investor who was not a member of that pool would need to be satisfied that the relevant investment opportunity could be offered at an appropriate cost. Because the contracts supporting each pool are based on an assumption that only those named authorities who have contributed to the establishment are eligible investors, these would, in most cases, have to be amended.

Question 9: Do you agree with the proposed requirements for the levelling up plan to be published by funds?

Please see our comments above regarding making levelling up a “requirement”. We have no issue with authorities stating what their policy on levelling up is if the proposal can be legitimately included within statutory guidance[5]. However, we strongly reject the proposal that funds should be directed in revised Regulations to invest up to 5% of their assets in local investments.

Question 10: Do you agree with the proposed reporting requirements on levelling up investments?

No. For the reasons above, we disagree with increased reporting of levelling up investments.

Chapter 4: Investment opportunities in private equity

Question 11: Do you agree that funds should have an ambition to invest 10% of their funds into private equity as part of a diversified but ambitious investment portfolio? Are there barriers to investment in growth equity and venture capital for the LGPS which could be removed?

No. We are agnostic on the case for further investment in private equity by LGPS authorities, but there should be no compulsion to do so and no prescribed ambition of a given asset allocation, especially with a geographical bias to the UK. The reasons for this have already been stated earlier in our response. The risk to the Government of judicial review for exceeding its powers (following the principles of Palestine) is the same for the private equity proposals as for the levelling up proposals.

We would note that the chapter is concerned wholly with private equity and would suggest that if there is a case to be made for private markets that should cover credit too.

Question 12: Do you agree that LGPS should be supported to collaborate with the British Business Bank and to capitalise on the Bank’s expertise?

We see no reason to prevent authorities or pool operators from engaging with the BBB if they wish to do so. We did not understand the reference in paragraph 90 that suggests that there are barriers in legislation that need to be overcome.

Chapter 5: Improving the provision of investment consultancy services to the LGPS

Question 13: Do you agree with the proposed implementation of the Order through amendments to the 2016 Regulations and guidance?

We agree with the proposal to set investment objectives for investment consultancy service providers. However, we wish to make a comment about the exemption from tendering for pool operating companies which are Teckal companies. There is an important difference between permitting authorities to avoid the need for retendering fiduciary management contracts (if that is

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[5] See our general comments on the implications of the Palestine case regarding the improper use of statutory power.

what they have entered into with their wholly owned pool operators) and the enhanced governance goal of setting investment objectives and measuring consultants against how they deliver on those objectives. The case is all the stronger in a public sector scheme where the pool operators are only regulated by the Financial Conduct Authority and not directly answerable to the Government.

Chapter 6: Updating the LGPS definition of investments

Question 14: Do you have any comments on the proposed amendment to the definition of investments?

No, this seems a sensible minor amendment to the Investment Regulations.

Response ends.

Yours faithfully,

Clifford Sims
Chair, Public Sector Group, SPP

Fred Emden
Chief Executive, SPP

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