Committee:	Date:
Financial Investment Board	4 February 2016
Subject: Local Government Pension Scheme – Investment Reform Criteria & Guidance and Consultation on Investment Regulations	**Public**
Report of: Chamberlain	**For Information**
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Summary

The Government has published its the Investment Reform Criteria and Guidance (Criteria and Guidance) for the Local Government Pension Scheme (LGPS) alongside a consultation on new draft Investment Regulations to replace the 2009 LGPS (Management and Investment of Funds) Regulations.

Local authorities are expected to bring forward proposals for pooling their investments whilst the consultation on the Investment Regulations proposes to relax the current regulatory framework, but also to introduce safeguards including measures to ensure that those authorities who do not bring forward ambitious proposals for pooling should be required to pool.

In terms of the City's response to the Investment Reform Criteria and Guidance we will use the London CIV's response as the basis for our response. The response will be circulated to the Chairmen of Investment Committee, Financial Investment Board, Policy and Resources Committee, Finance Committee and the Town Clerk prior to submission to the Government. For the draft Investment Regulations, Officers are considering how best to respond to this consultation and any response will be circulate to the Chairman of the Financial Investment Board.

Recommendation

Members are asked to note the report.

Main Report

Background

1. In the July 2015 budget, the Chancellor announced that it was the Government's intention to invite administering authorities of England and Wales to bring forward proposals for pooling the Local Government Pension Scheme (LGPS) investments to deliver significantly reduced costs, whilst maintaining investment performance. The initial indications were for 5-6 pools of investments of £25-30bn.

2. In November 2015, the Government published the Investment Reform Criteria and Guidance (Criteria and Guidance) alongside a consultation on new draft

Investment Regulations to replace the 2009 LGPS (Management and Investment of Funds) Regulations. Responses are required by 19 February 2016 on

(i) how authorities plan to pool investments in outline and
(ii) whether the amended regulations provide sufficient flexibility for authorities to undertake pooling.

3. The Investment Reform Criteria and Guidance is not a consultation document - the criteria are predetermined and authorities are now being invited to submit proposals for pooling their assets which the Government will assess against the criteria and guidance laid out in the paper. Further detailed proposals for pooling are required by 15 July 2016

4. The documents can be found at https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance and https://www.gov.uk/government/consultations/revoking-and-replacing-the-local-government-pension-scheme.

5. The Government has also published its response to the 2014 consultation *Opportunities for collaboration, cost savings and efficiencies* which received 200 responses. This can be found at https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies

6. The City has been involved in the establishment of the London CIV as way to deliver fee savings and wider governance benefits to the LGPS in London and along with 30 other London authorities, is a shareholder. At this stage the Government has asked for "initial proposals" which should include "*a commitment to pooling and a description of progress towards formalising arrangements*". The Government are happy to receive collective responses from pools and/or individual responses from LGPS funds.

7. The London CIV have drafted a response for submission although some London authorities are planning to submit a separate response. There will be considerable work to be done between February and July to pull together all of the information that the Government requires. In addition all authorities will need to identify elements of the Pension Fund that might be kept out of the pool at the outset (e.g. property funds with long duration).

8. The City of London is a Member of the London CIV and the Chairman of Policy and Resources Committee is the Chairman of the Pension CIV Sectoral Joint Committee.

9. Authorities are expected to make plans to transfer assets to pools as soon as is practicable with liquid assets being transferred into pools over a relatively short time frame beginning from April 2018 and illiquid assets transitioning over a longer period of time.

Investment Reform Criteria and Guidance

10. The government's objectives are clear in the Ministerial Foreword to the Criteria and Guidance:

    "*Working together, authorities have a real opportunity to realise the benefits of scale that should be available to one of Europe's largest funded pension schemes. The creation of up to six British Wealth Funds, each with at least £25bn of Scheme assets, will not only drive down investment costs but also enable the authorities to develop the capacity and capability to become a world leader in infrastructure investment and help drive growth.*"

11. In their submissions, authorities should include a commitment to pooling and a description of progress towards formalisation of arrangements with other authorities. Authorities can choose whether to submit individual or joint proposals or both at this stage. The submissions in July are expected to address fully the criteria set out by Government and comprise:

    - for each pool, a joint proposal from participating authorities setting out the pooling arrangement in detail. For example, this may cover the governance structures, decision-making processes and implementation timetable; and
    - for each authority, an individual return detailing the authority's commitment to, and expectations of, the pool(s). This should include their profile of costs and savings, the transition profile for their assets, and the rationale for any assets they intend to hold outside of the pools in the long term.

12. The Criteria and Guidance sets out four criteria and it is for authorities to suggest how their pooling arrangements will be constituted.

    - Asset Pool(s) that achieve the benefits of scale
    - Strong Governance and decision making
    - Reduced costs and excellent value for money
    - An improved capacity to invest in infrastructure

    Appendix 1 sets out in detail what Authorities are expected to explain in their submissions. The Criteria and Guidance includes a number of additional points that should be noted and these are set out in Appendix 2.

13. The initial submissions will be evaluated against the criteria with the Government providing feedback to highlight areas that may fall outside of the criteria or where additional evidence may be required. Once the final proposals have been submitted and assessed against the criteria, a brief report will be provided highlighting any aspects of the guidance that they believe has not been adequately addressed.

14. For authorities who do not develop sufficiently ambitious proposals, the Government will, in the first instance, work with them to help deliver a more cost effective approach to investment that draws on the benefits of scale. Where this is not possible, the Government will consider how else it can drive value for money for taxpayers including the use of "backstop" legislation.

15. The Government has emphasised that authorities should continue to manage their investment strategies and any manager appointments until new arrangements are in place.

16. To assist authorities in developing their proposals the Government has provided for information only a copy of PwC's technical analysis of different collective investment vehicles (https://www.gov.uk/government/publications/local government-pension-scheme-investment-reform-criteria-and-guidance) and strongly encourages authorities to learn from others who have already begun the journey of developing collective investment vehicles such as the London CIV and the LPFA/Lancashire venture.

17. Once the London CIV have finalised their response, Officers will use this as the basis of the City's response. The response will be circulated to the Chairmen of Investment Committee, Financial Investment Board, Policy and Resources Committee, Finance Committee and the Town Clerk prior to submission to the Government.

CONSULTATION – Revoking and Replacing the LGPS Management and Investment of Funds) Regulations 2009

18. The Government has issued a consultation paper on revoking and replacing the LGPS (Management and Investment of Funds) Regulations 2009. Amending or replacing the 2009 Regulations has been under discussion for a number of years and with the requirement for pooling, this has reinforced the need to amend the existing investment regulations.

19. The consultation proposes to relax the current regulatory framework, but to introduce safeguards. The Chancellor's July Budget indicated that measures should be introduced to ensure that those authorities who do not bring forward ambitious proposals for pooling, in keeping with the Criteria should be required to pool and these are included in the draft Regulations.

20. There are two main areas of reform:

    - A package of reforms that propose to remove some of the existing prescribed means of securing a diversified investment strategy and instead place the onus on authorities to determine the balance of their investments and take account of risk. (Proposal 1)
    - The introduction of safeguards to ensure that the more flexible legislation proposed is used appropriately and that the guidance on pooling assets is adhered to. This includes a suggested power to allow the Secretary of State to intervene in the investment function of an administering authority when necessary. (Proposal 2)

21. The Government is seeking views on whether the revisions will enable sufficient flexibility for authorities to determine a suitable investment strategy that appropriately takes account of risk and whether the proposals to introduce the power of intervention as a safeguard will enable the Secretary of State to intervene (were appropriate) to ensure that authorities take advantage of the

benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.

22. Appendix 2 sets out the proposals in more detail along with the 8 questions that authorities are being asked to respond to.

23. Officers are considering how best to respond to this consultation and any response will be circulated to the Chairman of the Financial Investment Board.

Conclusion

24. The City is intending to respond to the Criteria and Guidance using the London CIV response as a basis, and the consultation on the draft Investment Regulations.

Appendices

- Appendix 1 - Investment Reform Criteria and Guidance
- Appendix 2 - Investment Reform Criteria and Guidance – Additional Points
- Appendix 3 - Consultation – Revoking and Replacing the LGPS Management and Investment Regulations 2009

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Appendix 1

Investment Reform Criteria and Guidance

Asset Pool(s) that achieve the benefits of scale – the 90 Administering Authorities in England and Wales should collaborate to establish and invest through pools of at least £25bn of assets. Authorities are therefore now required to explain:

- The size of their pool(s) once fully operational.
- In keeping with the supporting guidance, any assets they propose to hold outside the pool(s), and the rationale for doing so.
- The type of pool(s) they are participating in, including the legal structure if relevant.
- How the pool(s) will operate, the work to be carried out internally and services to be hired from outside.
- The timetable for establishing the pool(s) and moving their assets into the pool(s). Authorities should explain how they will transparently report progress against that timetable.

Strong Governance and decision making – The proposed governance structure for the pools should:

a) At the local level, provide authorities with assurance that their investments are being managed appropriately by the pool, in line with their stated investment strategy and in the long-term interests of their members;
b) At the pool level, ensure that risk is adequately assessed and managed, investment implementation decisions are made with a long- term view, and a culture of continuous improvement is adopted.

Authorities are also required to explain:

- The governance structure for their pool(s), including the accountability between the pool(s) and elected councillors, and how external scrutiny will be used.
- The mechanisms by which the authority can hold the pool(s) to account and secure assurance that their investment strategy is being implemented effectively and their investments are being well managed.
- Decision making procedures at all stages of investment, and the rationale underpinning this.
- The shared objectives for the pool(s), and any policies that are to be agreed between participants.
- The resources allocated to the running of the pool(s), including the governance budget, the number of staff needed and the skills and expertise required.
- How any environmental, social and corporate governance policies will be handled by the pool(s).
- How the authorities will act as responsible, long term investors through the pool(s), including how the pool(s) will determine and enact stewardship responsibilities.
- How the net performance of each asset class will be reported publically by the pool, to encourage the sharing of data and best practice.

- The extent to which benchmarking is used by the authority to assess their own governance and performance and that of the pool(s), for example by undertaking the Scheme Advisory Board's key performance indicator assessment.

Reduced costs and excellent value for money – Proposals are required explaining how the pool(s) will deliver substantial savings in investment fees both in the near term and over the next 15 years, whilst at the same time maintaining investment performance.

It further emphasizes that active fund management should only be used where it can be shown to deliver value and authorities are required to report how fees and net performance in each listed asset class compare to a passive index. Authorities should consider setting targets for active managers which are focused on achieving risk-adjusted returns over an appropriate long term period rather than focusing on short term performance comparisons. As part of the proposals, authorities should provide:

- A fully transparent assessment of investment costs and fees as at 31 March 2013.
- A fully transparent assessment of current investment costs and fees, prepared on the same basis as 2013 for comparison.
- A detailed estimate of savings over the next 15 years.
- A detailed estimate of implementation costs and when they will arise, including transition costs as assets are migrated into the pool(s), and an explanation of how these costs will be met.
- A proposal for reporting transparently against their forecast transition costs and savings, as well as how they will report fees and net performance.

An improved capacity to invest in infrastructure – Only a small proportion of LPGS assets are currently invested in infrastructure - it is estimated at 0.3% compared to large international pension funds of 10-15% of assets under management. The Government sees the scales that investment pools bring as offering real scope to increase the exposure to infrastructure assets. Authorities are therefore required as part of their submission to cover:

- The proportion of their fund currently allocated to infrastructure, both directly and through funds, or "fund of funds".
- How they might develop or acquire the capacity and capability to assess infrastructure projects, and reduce costs by managing any subsequent investments directly through the pool(s), rather than existing fund, or "fund of funds" arrangements.
- The proportion of their fund they intend to invest in infrastructure, and their ambition in this area going forward, as well as how they have arrived at that amount.

Appendix 2

Investment Reform Criteria and Guidance – Additional Points

- Government expects all administering authorities in England and Wales to pool their investments to achieve economies of scale and the wider benefits of sharing best practice.
- It expects authorities to collaborate and invest through no more than six large asset pools each with at least £25bn of LGPS assets under management once fully operational.
- There may be limited scope to allow smaller pools but only for bespoke circumstances where an alternative arrangement may be more appropriate for a particular asset class such as infrastructure, direct holdings in property and locally targeted investment.
- Whilst the presumption is that all investments should be made through the pool, the Government recognize that there may be a limited number of existing investments that might be less suited to pooled arrangements such as local initiatives or products tailored towards specific liabilities, although any exemptions must be minimal and demonstrate clear value for money.
- The Government is prepared to accept that some existing property assets might be more effectively managed directly and not through a pool at present. However, pools should be used if new allocations are made to property, taking advantage of the opportunity to share the costs associated with the identification and management of suitable investments.
- Determining the investment strategy and setting the strategic asset allocation should remain with individual authorities but that the implementation of that strategy will be delegated to officers or the pool. Manager selection will need to be undertaken at the pool level.
- When developing proposals, authorities need to take into consideration procedures and mechanisms to facilitate long term responsible investing and stewardship through the pool.
- Environmental, social and corporate governance policy (ESG) should be taken into consideration both at an individual authority and pool level and how the authority's individual views can be reflected in the pool. The Government intends to issue guidance to authorities that ESG policies should not run contrary to Government policy.
- The extent to which passive management is used will remain a decision for each authority or pool, but authorities are encouraged to keep their balance of active and passive management under review
- The Local Government Pension Scheme Advisory Board is commissioning advice to help authorities fully assess all investment costs which should be taken into account when coming forward with proposals.
- No overall savings target from the proposals has been set, the Government expects authorities to take full advantage of the benefits of pooling to reduce costs whilst maintaining performance.
- Developing larger investment pools will make it easier to develop or acquire improved capacity and capability to invest in infrastructure. The Government believes that authorities can play a leading role in UK infrastructure and driving local growth.

- Authorities are expected to make plans to transfer assets to pools as soon as is practicable. Government expects liquid assets are transferred into pools over a relatively short time frame beginning from April 2018 with illiquid assets transitioning over a longer period of time. Investments with high penalty costs for early exit should not be wound up early on account of the pooling arrangements but should be transferred across as soon as is practicable taking into account value for money.

Appendix 3

CONSULTATION – Revoking and Replacing the LGPS Management and Investment of Funds) Regulations 2009

Proposal 1: Adopting a Local Approach to Investment

Deregulation and Adopting a local approach to investment

In coming forward with this proposal the Government is seeking to deregulate and simplify the investment regulations that have been in place since 2009 by removing a number of restrictions, e.g. the requirement for funds to ensure an adequate number of managers and removing restrictions around the choice and terms of investment manager appointments.

Investment Strategy Statement

The proposals will also see the removal of the existing schedule of limitations on investments with authorities expected instead to adopt a 'prudential' approach, demonstrating they have given consideration to the suitability of different types of investments, have appropriate diversification, corporate governance and risk management. A new Investment Strategy Statement will be required of Funds, replacing the current Statement of Investment Principles. This Statement must cover:

- A requirement to use a wide variety of investments.
- The authority's assessment of the suitability of particular investments and types of investments.
- The authority's approach to risk, including how it will be measured and managed.
- The authority's approach to collaborative investment, including the use of collective investment vehicles and shared services.
- The authority's environmental, social and corporate governance policy.
- The authority's policy on the exercise of rights, including voting rights, attached to its investments.

Authorities will be required to publish an Investment Strategy Statement no later than 6 months after the regulations come into force (expected to be 1st April 2016) and existing provisions in current regulations around restrictions will remain in force until such time as the authority publishes its first Statement.

Non-Financial Factors

Included within the consultation is a section on non-financial factors, as follows:

"*The Secretary of State has made clear that using pensions and procurement policies to pursue boycotts, divestments and sanctions against foreign nations and the UK defence industry are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government. The Secretary of State has said, "Divisive policies undermine good community relations, and harm the economic security of families by pushing up council tax. We need to challenge and prevent the politics of division.*

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 already require administering authorities to publish and follow a statement of investment principles, which must comply with guidance issued by the Secretary of State. The draft replacement Regulations include provision for administering authorities to publish their policies on the extent to which environmental, social and corporate governance matters are taken into account in the selection, retention and realisation of investments. Guidance on how these policies should reflect foreign policy and related issues will be published ahead of the new Regulations coming into force. This will make clear to authorities that in formulating these policies their predominant concern should be the pursuit of a financial return on their investments, including over the longer term, and that, reflecting the position set out in the paragraph above, they should not pursue policies which run contrary to UK foreign policy."

<u>Questions</u>

The questions raised under the consultation are set out below:

1. Does the proposed deregulation achieve the intended policy aim of removing any unnecessary regulation while still ensuring that authorities' investments are made prudently and having taken advice?
2. Are there any specific issues that should be reinstated? Please explain why.
3. Is six months the appropriate period for the transitional arrangements to remain in place?
4. Should the regulation be explicit that derivatives should only be used as a risk management tool? Are there any other circumstances in which the use of derivatives would be appropriate?

<u>Proposal 2: Introducing a safeguard – Secretary of State Power of Intervention</u>

In proposing new flexibilities around investment under Proposal the Government is keen to ensure that such flexibilities are used appropriately. The consultation therefore proposes to introduce a power for the Secretary of State to intervene in the investment function of an Administering Authority if the Secretary of State believes that the Authority has not had regard to guidance and regulations. In addition, the draft power to intervene could be used to address authorities that do not bring forward proposals for pooling their assets in line with the published criteria and guidance.

<u>Determining to intervene and process of intervention</u>

In reaching a decision on whether to intervene, the Secretary of State will need to consider evidence as to whether the authority has failed to have regard to the regulations or guidance issued under regulation, such evidence could include ignoring information on best practice, failing to follow investment regulations and guidance or undertaking a pension-related function poorly e.g. in respect of actuarial valuations where they are not consistent with other authority valuations. If the Secretary of State is satisfied that intervention is required, then he/she can draw on external advice to determine what specific intervention might be necessary. Examples of proposed intervention might include but are not limited to:

- Requiring an administering authority to develop a new investment strategy statement that follows guidance published under draft Regulation 7(1).
- Directing an administering authority to invest all or a portion of its assets in a particular way that more closely adheres to the criteria and guidance, for instance through a pooled vehicle.
- Requiring that the investment functions of the administering authority are exercised by the Secretary of State or his nominee.
- Directing the implementation of the investment strategy of the administering authority to be undertaken by another body.

The Secretary of State will write to the authority outlining the proposed intervention, which as a minimum will include:

- A detailed explanation of why there is an intervention and the evidence used to arrive at this determination.
- A clear description of the proposed intervention and how it will be implemented and monitored.
- The timetable for the intervention, including the period of time until the intervention is formally reviewed.
- The circumstances under which the intervention might be lifted prior to review.

<u>Questions</u>

The questions raised under the consultation are set out below:

5. Are there any other sources of evidence that the Secretary of State might draw on to establish whether an intervention is required?
6. Does the intervention allow authorities sufficient scope and time to present evidence in favour of their existing arrangements when either determining an intervention in the first place, or reviewing whether one should remain in place?
7. Does the proposed approach allow the Secretary of State sufficient flexibility to ensure that he is able to introduce a proportionate intervention?
8. Do the proposals meet the objectives of the policy, which are to allow the Secretary of State to make a proportionate intervention in the investment function of an administering authority if it has not had regard to best practice, guidance or regulation?