THE INVESTMENT ASSOCIATION

LGF Pensions Team
Ministry of Housing, Communities and Local Government
Sent by email to LGPensions@communities.gov.uk

16th January 2025

Dear LGF Pensions Team,

RE: Investment Association response to 'LGPS (England and Wales): Fit for the future'

The Investment Association (IA) welcomes the opportunity to respond to the MHCLG consultation on the next stage of pooling in the English and Welsh LGPS. Given its size and unique position as an open DB scheme in the context of a broader decline in DB provision in the UK and beyond, the LGPS has an important role to play as a provider of both risk capital to the UK economy and sustainable and affordable guaranteed pensions to its members.

While the structure of the LGPS is solely a matter for the scheme and central and local governments, we believe the overall rationale for investment pooling is sound and have been supportive of its implementation since 2015.

The broader context surrounding the current consultation is that the 2016 changes to the LGPS investment regulations[1] have paved the way for the LGPS to allocate to a broader range of asset classes, with a particularly pronounced trend seen in growing allocations to alternative asset classes in recent years[2]. LGPS performance has been strong both historically and more recently. Over the last ten years, the average LGPS fund has delivered a nominal return of around 7%pa. Longer term (20-30 years) the results are stronger still at almost 8%pa nominal[3]. These outcomes, delivered in an increasingly competitive cost environment, point to a strong foundation on which to build for the future.

With regard to the current consultation, we are supportive of the additional impetus for further pooling and have provided our answers to selected consultation questions.

In addition, we wish to make a number of specific points:

1. <u>Central importance of 'sophisticated scale'</u>. Scale works when implemented in a way that facilitates the following key characteristics:

- Strong investment governance and oversight, together with high standards of accountability.
- Appropriate levels of investment expertise that covers knowledge of investment opportunities across the full range of asset classes and markets, including more niche areas.

[1] The Loval Government Pension Scheme (Management and Investment of Funds) Regulations 2016
[2] LGPS Annual Report 2023, Scheme Advisory Board
[3] Ibid.

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- Sophisticated investment procurement that considers where internal and external management can add value, as well as being able to identify and work with a wide range of investment managers, from small, specialised firms to large global managers.

These are the features through which LGPS pools can deliver value to their partner funds, and we term this 'sophisticated scale'.

The consultation implies in a number of places that a combination of scale and FCA authorisation is intended to lead to the creation of internal investment management capabilities that replace external managers. Moving to an FCA authorised pool structure should not automatically lead to a binary decision as to whether the pool uses internal or external management. The starting point for sophisticated scale is to ensure a governance and implementation framework that can properly identify the right balance between internal and external for a given set of investment requirements.

A key area of focus for the LGPS pools will therefore be in selecting where internal and external managers can best deliver value. While cost can be a driver of the decision to internalise investment management, it is not the sole reason, and pension schemes will take a broader range of factors, as detailed below, into account when making this decision.

Indeed, most schemes that are in a position to manage internally will typically be choosing a mixed approach, reflecting the fact that some of the most successful pension schemes globally will seek to build in-house expertise in some areas while relying on external expertise in others, accessing scale and expertise by leveraging external managers' global know-how and networks. It is very common, for example, for internal teams to perform asset allocation themselves, but then implement this using external managers. Equally there could be a combination of both approaches within the same asset class, or similar strategies could be managed internally and externally – this will naturally evolve over time. There is also scope to employ both internal and external approaches within the investment process in relation to individual activities, for example outsourced trading or technology solutions.

Beyond a simple driver to reduce costs, there are a number of factors that will be taken into account when considering internal or external management:

- <u>Synergies between internal and external management</u>. By building up internal expertise this might help with oversight and decision-making in relation to external managers as well, helping to maximise the value of employing them.

- <u>Commercial considerations in a given market</u>. Investment strategies that can be purchased for a low fee externally would generally be outsourced, as there is little benefit to spending the money to build internal resource in such instances. This is generally the case for index investment strategies, for example.

- <u>Nature of strategies and asset classes</u>. Those that are more complex or expensive to invest in, and where there is desire for the scheme to exercise greater direct control over the investments, may be candidates for internal management. This is true of some private asset classes.

- <u>Duration of any allocation to a strategy or asset class</u>. If a scheme's allocation to an asset class is only for the short to medium term, it is unlikely to want to dedicate resource to building an internal team and it may be more appropriate to outsource. Conversely, if the scheme intends to have a long-term allocation to an asset class, then internal management might be more feasible.

- <u>Impact of capacity constraints in external managers' strategies</u>. Where increases in AuM to a strategy make it hard for the manager to deliver outperformance, investors may be limited from investing further in the strategy by the manager. In such cases a large scheme may choose to use internal management to implement the desired strategy. However, it should be noted that where capacity constraints arise from the scale of market-wide opportunities, this will be a challenge for both internal and external managers alike.

- Alignment with investment process. Whether the scheme considers the scope for internal management to have greater alignment of the investment process with the specific objectives of the scheme and its beneficiaries e.g. lack of potential conflicts in areas such as profitability, shareholder accountability or minimising performance risk relative to peers.
- Wider service considerations. The extent to which the scheme wants a singular focus on the investment process, without the wider functions that external managers must think about e.g. client servicing and marketing. Portfolio managers and investment teams at external managers often spend time in front of multiple clients, a feature that internal teams would not face to the same degree. Schemes wanting a more singular, dedicated focus may opt for some internal management.

Of course, the ultimate driver for these decisions will be investment performance, net of costs. Managers that do not deliver – whether they are internal or external – will be replaced. Policy should therefore not emphasise the choice of one over the other: the use of a balance of internal and external managers is the outcome of good investment governance.

A broader governance point to consider in this context is that the pool manager is different from other investment managers in an important respect: the administering authorities will not be able to easily switch away from the pool manager should they be making poor decisions or breaching their obligations. Currently, administering authorities can at least keep some assets out of the pool, but a requirement to pool more assets will result in their exposure to the pool's management being greater. Maintaining flexibility will be important rather than nudging pool companies to be run in one direction over another.

2. Enhanced pooling model may require more flexibility in some areas. The experience of pooling to date has generally been a success, with the pools providing high quality and professional investment implementation across a broader range of asset classes. We are therefore supportive of the planned direction of travel on pooling.

However, some pragmatism is necessary in the approach to certain investments as well as the overall timeline:

- Index investments should be considered pooled due to existing efficiencies and the operational challenges of further pooling, discussed further in our response to Q7.
- Transferring existing illiquid investments to pools may incur additional costs without significant benefits. An alternative approach would involve administering authorities ceasing to make new illiquid investments outside their pools by March 2026, with pools supporting the oversight of legacy assets.
- The Government's target that the pools become FCA regulated by March 2026 is challenging. It risks new structures being adopted that are not optimal and so we encourage the Government to extend this period, perhaps allowing the pools two years from when the rules are finalised to determine their structure and apply for FCA authorisation.

3. Local investment targets are for the LGPS to decide but could be set to include a broader range of economic activity. As the consultation notes, the primary purpose of the LGPS is to pay the pensions of its membership. It is not clear that this is always consistent with compulsory investment targets, be they local or otherwise. The risk with mandatory local investment targets is the perception that the Government is using LGPS investment pools to supplement public spending which, if not successful, may result in local taxpayers and employers picking up any shortfall.

Ultimately it is for the LGPS and its stakeholders to decide on the feasibility and desirability of a formal target. An alternative to a formal target could be for Government to require administering authorities and pools to assess a range of local/regional investments. These could progress if consistent with an Administering Authority's investment objectives.

In thinking about an appropriate definition of local investment, there is scope for government to do more to help the LGPS and its investment managers facilitate investment in the local areas covered by LGPS administering authorities and pools. The opportunity set could include publicly listed companies. Bringing UK mid and small cap quoted companies within the definition would help the LGPS to support existing entities with infrastructure, businesses, factories and estates already operating in and contributing to local communities – protecting existing capital investment and promoting growth and development.

I hope this response is helpful and would be happy to discuss it further.

Yours sincerely

Imran Razvi
Senior Policy Adviser, Pensions & Institutional Market

Response to consultation

LGPS (ENGLAND & WALES): FIT FOR THE FUTURE

About the Investment Association

The Investment Association (IA) champions UK investment management, a world-leading industry which helps millions of households save for the future while supporting businesses and economic growth in the UK and abroad. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base. Collectively, they manage £9.1 trillion for savers and institutions, such as pension schemes and insurance companies, in the UK and beyond. 49% of this is for overseas clients. The UK asset management industry is the largest in Europe and the second largest globally.

Response to selected consultation questions

LGPS Pooling

1. **Do you agree that all pools should be required to meet the minimum standards of pooling set out above?**

2. **Do you agree that the investment strategy set by the administering authority should include high-level investment objectives, and optionally, a high-level strategic asset allocation, with all implementation activity delegated to the pool?**

3. **Do you agree that an investment strategy on this basis would be sufficient to meet the administering authority's fiduciary duty?**

4. **What are your views on the proposed template for strategic asset allocation in the investment strategy statement?**

5. **Do you agree that the pool should provide principal investment advice on the investment strategies of its partner AAs? Do you see that further advice or input would be necessary to be able to consider advice provided by the pool – if so, what form do you envisage this taking?**

<u>Combined answer to Qs 1 - 5</u>

The structure of the LGPS is a matter for the scheme itself and Government to agree upon. In particular, the balance of investment decision-making and governance between the pools and the underlying local authorities that own them, and indeed, the number of pools in operation in the long run, are matters that are best determined by central government in collaboration with the LGPS.

Our members' experience has been that pooling has generally been a success, with the pools providing high quality and professional investment implementation across a broader range of asset classes. We are therefore supportive of the planned direction of travel on pooling – subject to specific views on some operational matters discussed in our responses to questions 6-8.

While the proposals in this consultation generally shift more investment decision-making responsibility from administering authorities to the pools, one area to consider is whether certain local investment functions might be better shared at both individual Administering Authority (AA) and pool level, as doing so would allow for a broader range of objectives to be met. For example, in relation to an asset class like private equity (PE), at pool level, with a larger amount of capital to allocate, the pool would likely want to allocate larger tranches of money. While this may be well suited to some projects, mechanisms are needed to ensure available funding for more local, micro investments which might typically be at much smaller scale and could make more of a local impact.

In addition, appropriate investment governance and risk-management mechanisms will be needed to address the different exposures that will arise at a pool level, given that the AA of one area would be exposed to the local investments made to accommodate the preferences of an AA of another area.

With regards to the provision of investment advice, in a pooling model where investment advice and implementation is provided by the pools – akin to a Fiduciary Management model used by some corporate pension plans – AA Pension Committees will need to assess what further advice might be needed to carry out their oversight of the pools' activities.

6. Do you agree that all pools should be established as investment management companies authorised by the FCA, and authorised to provide relevant advice?

This is ultimately a matter for the Government to decide on. Our members' experience is that the pools – both the FCA-regulated firms and the non-regulated entities – have successfully delivered high quality investment implementation across a broad range of asset classes. However, the direction that Government is seeking for the pools, with the ambition of more internal investment management and the provision of investment advice, alongside continuing to work with external managers as appropriate, suggests that an FCA-regulated entity may be better suited to such a model.

As part of any shift to FCA-regulated status it is important for pool accountability to administering authorities that any new governance framework should ensure that administering authorities can as a last resort exit a pool or collectively bring about a change in pool management or strategy.

On area of concern is that the Government's target for the pools to become FCA regulated by March 2026 is challenging. It risks new structures being adopted that are not optimal. We encourage the Government to extend this period, allowing the pools two years from when the rules are finalised to determine their structure and apply for FCA authorisation. A longer lead-in period might ensure better outcomes at the end of the process.

7. Do you agree that AAs should be required to transfer all listed assets into pooled vehicles managed by their pool company?

We are generally supportive of a requirement for all listed assets to be transferred into pooled vehicles managed by the pool company, albeit with a number of caveats.

In the specific case of index investments, we question whether a mandatory requirement is the best approach for LGPS members and local taxpayers for a number of operational and resource-related reasons:

- Index investments are typically already procured in large, liquid and low-cost pools. These assets already receive oversight from their pool owners, including the ability to implement split voting on these assets in line with the pool's responsible investment policy, and there is no obvious value for them to be replicated within a pool. In our view the original pooling criteria of benefits of scale, reduced costs, maintaining investment performance and delivering excellent value for money have been, and continue to be, achieved via index investment in external funds.

- IA members report that existing procurement frameworks e.g. the National LGPS Framework for Passive Investment Management Services have had an impact on market pricing, helping LGPS investors to benefit from some of the lowest fees for index investment mandates. At such fee levels, it is unlikely that bringing these assets within the pools would result in cost savings for the LGPS. Furthermore, the transition costs (see below) could lead to a net negative cost impact from attempting to pool index assets.

- There are some significant operational challenges involved with pooling index investments that could lead to increased costs and reduced choice for LGPS investors. Index investments by LGPS are either made through life insurance contracts or ACS fund structures. While the investments made through an ACS structure could transition to a pooled platform, this is not always the case for life contracts. In these instances, investments held in life wrappers would need to be sold, with the underlying investments then repurchased through an ACS, creating unnecessary transition costs and pricing risks for LGPS investors, which could be especially significant in some markets. There are also implications for portfolio construction, since not all life contracts will have an equivalent ACS vehicle available, therefore reducing investment options for the LGPS.

Given the fact that the LGPS already benefits from pooled procurement, alongside the operational challenges involved, we believe that where funds and pool companies have chosen not to pool index investments this is because the costs will outweigh any benefit to LGPS funds and local taxpayers. We therefore strongly recommend that index investments should instead continue to be already considered pooled (under management of the pool).

While the above arguments are specifically about index investments, elements of them generalise to some actively managed listed assets. In such instances we are supportive of a principle that the pooling of assets should take place only where the benefits of doing so outweigh the costs.

8. Do you agree that administering authorities should be required to transfer legacy illiquid investments to the management of the pool?

With fees already negotiated, and generally unable to be adjusted post-commitment, transferring these assets to pools may simply incur additional tax and legal costs, with no significant benefit. It may therefore be more appropriate to agree that individual administering authorities should not seek to make new illiquid investments outside their pool from March 2026, with the pools playing a significant part in the oversight of legacy illiquid assets as they run-off. For example, responsibility could be delegated to the pool (via Power of Attorney or similar) on matters such as managing drawdowns, dealing with distributions, taking Limited Partner Advisory Committee seats where appropriate and making decisions on partnership matters (e.g. extensions).

9. What scope is there to increase collaboration between pools, including the sharing of specialisms or specific local expertise? Are there any barriers to such collaboration?

The LGPS has a tradition of collaboration, and this has been shown again through pooling to date. In order to devoid duplication and cost, there may be merit in one pool providing another service or capability to another pool.

However, there will be a number of issues for pools and funds to consider in this, since it is really about opening up a pool's capabilities to external investors:

- It may be appropriate to limit external investors to investing only in existing strategies offered by other pools. Were an investor to request another pool to provide a new strategy that is not already offered to that pool's internal customers, the set up and running costs of such a proposition could impose undue and unwanted costs on existing shareholder customers.

- Where pool investment strategies have capacity constraints, the interests of internal shareholder customers vs external pool customers will need to be carefully balanced to ensure that the presence of the latter does not prejudice the interests of the former.

- The pricing on any given investment strategy applied to internal shareholder customers and external pool customers is likely to be different owing to the equity risk taken by the former as pool owners.

- Existing pools have been built with the needs of their current shareholding investor base in mind. In particular, the expectation is that these investors will be invested through the pools for the long term. Introducing external customers into the pool's investor base will create new dynamics with respect to the management of inflows and outflows, since external customers may not be invested with a pool for as long as internal ones. This will be a new challenge for the pools to manage, with liquidity management in particular becoming an area of greater focus.

Taking these issues into account, it is clear that permitting external customers into pools requires careful consideration. As long as these issues can be addressed by the pools and their internal and external customers, it should be possible to permit such cross-pool collaboration to take place.

13. What are your views on the appropriate definition of 'local investment' for reporting purposes?

The consultation focuses particularly on directing additional LGPS investment in private markets, especially towards venture capital and innovative local businesses, where there is perceived to be a gap in the availability of institutional capital to such businesses. Previous governments have also echoed this focus and boosting the supply of institutional capital to businesses in the private markets has received significant, justified, policy support in recent years.

However, in considering the definition of local investment, the government can do more to help the LGPS and its investment managers facilitate investment in the local areas covered by LGPS administering authorities and pools.

The opportunity set could include publicly listed companies. Bringing UK mid and small cap quoted companies within the definition would provide an option for the LGPS to support existing entities with infrastructure, businesses, factories and estates already operating in and contributing to local communities – protecting existing capital investment and promoting growth and development. Quoted small and mid-cap UK companies are critical to English and Welsh industry and no other Government measures to support capital in the UK address the existing listed sector, a major part of the UK economy. The LGPS has an excellent opportunity in this regard.