THE INVESTMENT ASSOCIATION

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2nd October 2023

Dear Sir/Madam

RE: Investment Association Response to 'LGPS: Next steps on investments'

The Investment Association (IA) welcomes the opportunity to respond to the DLUHC consultation on next steps on investments in the 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 the implementation of pooling since 2015. In regard to the current consultation, we are supportive of the additional impetus for further pooling, though have a number of comments on the proposals, which we summarise here and expand on in our answers to selected consultation questions:

Asset pooling in the LGPS

The benefits of scale are well known. It tends to go hand-in-hand with more resources dedicated to governance, greater bargaining power over fees with external managers, and greater sophistication in investment as pension schemes develop their investment expertise in specific areas. With various economic, capital market and regulatory changes in recent years, the governance burden on individual local authority funds has grown significantly. Creating greater scale in the LGPS should help to increase the resources and investment capabilities of the pools, thus helping ease the pressure on individual local authority funds.

Greater scale will also lead to an increasing focus on where the LGPS can best deliver value for money investment performance through its **use of internal and external investment management**. The consultation frames this debate in terms of internal management being a way to cut costs. We do not share this framing and expect that while the LGPS will build further internal capability in some areas, there will continue to be opportunities for external managers to add value to the scheme: it is simply not possible for the pools to have capabilities in all asset classes globally. The challenge for the LGPS will be in selecting where internal and external managers can best deliver value. We discuss some of the factors that will be relevant to these decisions.

While the **timeline for transition to completing pooling of assets** is a matter for the LGPS and central and local government, we would welcome further clarity with respect to the position for index strategies and legacy illiquid assets, where the benefits of pooling may be less obvious. Indeed, for index strategies, given the existing benefits of low-cost pools with LGPS asset owner oversight, we would recommend that these assets are already considered as being assets under pool management.

With regards to **governance and training** we are supportive of the direction of travel set out in the consultation. It is in the interests of all the LGPS's stakeholders to have knowledgeable, qualified local authority pension committees making investment strategy decisions and carrying out oversight of pool investment implementation. However, we would encourage government to not be too prescriptive in setting out particular governance models in guidance so as not to stifle innovation and the ability of local authority funds and their pools to respond to changing economic, market and regulatory circumstances.

While we are supportive of **greater transparency in LGPS investment** and support a more unified approach to asset allocation disclosure across the LGPS, the proposals on reporting of net savings from pooling and asset-class level performance and benchmarking across local authority funds, risk creating unintended consequences:

- Reporting savings from pooling comes with some empirical challenges that we highlight, as well as noting that a narrow focus on reducing costs may make it difficult for the government to achieve some of its ambitions for the LGPS in relation to private assets.

- Asset-class level reporting and benchmarking may be suitable for pools making manager selection decisions, but it is less helpful for funds that should instead be considering the returns of the total portfolio in relation to a liability-focused benchmark. Given differences in funding level, investment strategy and asset allocation across funds, investment performance is likely to be heterogeneous and so comparisons to other funds are unhelpful.

LGPS investments and levelling-up

In principle we agree that, in the name of aiding the government's levelling up objectives, funds should be able to invest through their own pool into another pool's investment vehicle, where a particular strategy or asset class that a fund wishes to allocate to is not available via its own pool. However, in permitting this there will be a number of practical issues for pools and funds to consider in relation to balancing the interests of existing and new investors in relation to costs, investment capacity constraints, shareholder risk and liquidity management.

Investment opportunities in private equity

While we understand and support the need for the LGPS to act as a greater provider of risk capital to the UK economy, we have concerns about the proposed ambition for the LGPS to allocate 10% of its assets to private equity. The focus should be on private assets more broadly and should also not be restricted to the UK. Broadening the definition in these areas will avoid the risk of asset price bubbles inflating if a large number of (LGPS) investors are seeking to invest in a relatively small pool of UK assets.

As long as attractive private investment opportunities exist in the UK, this broader ambition should be sufficient to ensure LGPS capital finances UK opportunities, and the government can play its part here by ensuring policy certainty in relevant areas in order to create a predictable and stable investment environment.

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

Yours Sincerely,
Imran Razvi
Senior Policy Adviser, Pensions & Institutional Market

Response to selected consultation questions

LGPS (England and Wales): Next steps on investments

About the Investment Association

The IA champions UK investment management, supporting British savers, investors and businesses. Our 250 members range from smaller, specialist UK firms to European and global investment managers with a UK base and manage £10.0 trillion of assets. The investment management industry supports 122,000 jobs across the UK. Our mission is to make investment better. Better for clients, so they achieve their financial goals. Better for companies, so they get the capital they need to grow. And better for the economy, so everyone prospers.

Our purpose is to ensure investment managers are in the best possible position to:

- Build people's resilience to financial adversity
- Help people achieve their financial aspirations
- Enable people to maintain a decent standard of living as they grow older
- Contribute to economic growth through the efficient allocation of capital

The money our members manage is in a wide variety of investment vehicles including authorised investment funds, pension funds and stocks and shares ISAs. The UK is the second largest investment management centre in the world, after the US and manages over a third (37%) of all assets managed in Europe.

Asset Pooling in the LGPS

Q1: 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?

The structure of the LGPS is a matter for the scheme itself and government to agree upon. In particular, the speed at which more assets are transitioned into the pools, 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.

While we set out some comments on these matters in our responses to subsequent questions, they are in relation to the practical issues involved in these changes, rather than taking a view on their desirability. We set out instead a number of comments that are relevant to the broader debate about pooling, specifically in relation to scale and internal vs external investment management.

The case for greater scale in the LGPS

Like other pension schemes in the UK and beyond, the LGPS has had to operate in a more complex and challenging environment in recent years:

- The move to pooling beginning in late 2015, which has involved significant work to reach today's current structure of eight pools, a number of which are FCA-regulated investment managers.

- The 2016 changes to the LGPS investment regulations[1], which removed much of the previous prescription around permitted investments, giving local authorities greater discretion in determining their investment strategies, but also introducing more detailed governance requirements in relation to investment strategies.

- Changes in regulation and developments in the capital markets that have seen pension schemes increasingly focus on areas such as sustainable investment and private assets.

- Changes in the macro environment which has seen schemes needing to navigate, at different points: turbulent equity markets; sustained falls in long term interest rates; the economic effects of the pandemic and the war in Ukraine; and most recently, the return of higher inflation and the associated rapid rise in both short and long-term interest rates.

Taking all these changes together the governance burden on individual local authority funds has grown significantly in recent years. In this context, creating greater scale in the LGPS should help to increase the resources and investment capabilities of the pools, thus helping ease the governance and regulatory burden on individual local authority funds.

More generally, the benefits of scale are well known. It tends to go hand-in-hand with more resources dedicated to governance, greater bargaining power over fees with external managers (since bigger mandates tend to lead to lower fee rates), and most importantly, greater sophistication in investment as pension schemes develop their investment expertise in specific areas (see below). In practice, some large schemes do invest differently to smaller schemes, with a greater likelihood of allocations to specialist and niche areas for specific reasons e.g. diversification, return, impact or liquidity for example.

Recent research[23] has shown that the largest institutional investors do add incremental value over and above smaller institutional investors, a result driven by a combination of implementing internal management in certain areas (primarily private assets), lower fees paid to external managers, and lower staffing costs per assets invested.

These points would seem to confirm the intuition that creating further scale in the LGPS would be beneficial.

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[1] The Loval Government Pension Scheme (Management and Investment of Funds) Regulations 2016
[2] A Case for Scale, CEM Benchmarking, 2022.
[3] Scale Economies, Bargaining Power and Investment Performance: Evidence from Pension Plans, Devries, Kalfa, Timmermann and Wermers, 2023

Internal and external investment management

The consultation notes that as the pools scale up *"there is potential to grow in-house investment management....to reduce or replace the use of external private sector investment managers. This should offer substantial reductions in cost[4]"*. 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 into account when making this decision.

Indeed, most schemes that are in a position to manage internally will typically be choosing a mix of the two, rather than one or other, reflecting the fact that pension schemes will seek to build in-house expertise in some asset classes and strategies while relying on external expertise in other areas. It is very common, for example, for internal teams to do asset allocation themselves, but then implement this using external managers.

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:

- 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.

- Strategies or asset classes 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.

- The duration of any allocation to a strategy or asset class: 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.

- The impact of capacity constraints in external managers' strategies: 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.

- 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.

- 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.

[4] Paragraph 15 of the consultation document.

- Synergies between internal and external management: by building up internal expertise this might help with oversight and decision-making in relation to external managers as well.

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.

Our expectation is that the LGPS will build further internal capability in some areas, but that there will continue to be opportunities for external managers add value to the scheme: it is simply not possible for the pools to have capabilities in all asset classes globally. The issue for the LGPS is to make sure it gets the balance between internal and external management correct, with the internal and external managers chosen where they can best add value.

Q2: 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?

While we support the general approach to LGPS pooling and believe the evidence shows that there is a rationale to build greater scale, we do not have a view on the precise date by which pooling of listed assets should be completed. This is an operational matter that individual funds and pools are best placed to provide a view on.

However, further clarity would be welcome in two areas:

<u>Index investments</u>

The proposals in the consultation document suggest that LGPS index investments would need to move to the LGPS pools. We question whether this 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, 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, life contracts could not. 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 costs of pooling index investments 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 ("assets under pool management" in the government's classification).

Illiquid assets

The status of existing illiquid holdings, particularly those in private markets, should be clarified. 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 local authorities should not seek to make new illiquid investments outside their pool from March 2025 (or whichever date government settles on), and the pools, where appropriate, support local authority funds on the oversight of legacy illiquid assets as they run-off.

Q3: 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?

Our understanding of the 2015 pooling model was that the primary purpose was to give the pools the responsibility for implementation of local authority pension fund investment strategies. However, responsibility for the investment strategy, and ultimately, the liabilities, remain with the local authority funds.

The approach set out in the current consultation reiterates this basic model, and since this is the government and LGPS's desired model, further guidance that strengthens this should be helpful.

That said, we would caution against the guidance being overly prescriptive in terms of the governance model set out. The risk of doing so would be that the guidance ends up stifling innovation and the ability of local authority funds and their pools to respond to changing economic, market and regulatory circumstances.

Given that local authorities remain responsible and accountable for their investment strategies and the payment of pensions, it is important that any governance model ensures they have proper oversight and scrutiny of investment implementation by the pools.

Q4: Should guidance include a requirement for administering authorities to have a training policy for pensions committee members and to report against the policy?

We fully support the principle that members of local authority pensions committees should have sufficient knowledge and expertise to carry out their role properly. This should include as much investment knowledge as is necessary to enable them to make investment strategy and asset allocation decisions and to provide effective oversight and scrutiny of their pool's investment implementation.

One of the benefits of pooling is that the delegation of investment implementation to the pools will somewhat reduce the knowledge and skills requirements on local authority pensions committees, relative to private sector pension trustees, making it easier to train members to the required standard.

Having a training policy in place will help local authority pensions committee members reach the appropriate level of knowledge. While it will be for local authorities to set out their own training policies, TPR's guidance for trustees may provide some assistance for designing such polices, where there is commonality between the role of trustees and pension committees.

We understand that there is currently a difference in the training requirements between Local Pension Boards (TPR-accredited bodies[5] that provide oversight of local authority pension committees) and the pensions committees themselves, which make investment decisions but are not TPR-accredited. We believe it is appropriate that the requirements for sitting on a local authority pensions committee should match that of membership of a Local Pension Board.

<u>The role of investment consultants in LGPS pooling</u>

Much like pension trustees, local pension committees also have the option to use investment consultants to assist them in their investment decision-making. To ensure the broader success of pooling, it is important to recognise and manage the potential conflict of interest that investment consultants may face in advising local authority funds on more complex investment strategies, including outside the pool, which may require a greater degree of advisory input.

In a pooling model where investment implementation is done by the pools and investment advice is increasingly also provided by the pools, consultants will be best able to add value by helping local pensions committees carry out their oversight of the pools' activities.

We have previously called for HMT to extend the FCA's regulatory perimeter to cover areas of investment consultant advice provided to pension schemes that are not already FCA-regulated (principally, asset allocation and manager selection)[6]. Regulation of this advice would benefit LGPS pension committees in the same way that it would benefit pension fund trustees.

Q5: 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 agree with the government that greater transparency on LGPS investment is in the public interest, given that the scheme is underwritten by local taxpayers. We do have a number of comments on the proposals, as follows:

<u>Asset allocation disclosure</u>

We welcome moves to disclose LGPS-wide asset allocation on a consistent basis. We would encourage the government to use existing asset allocation reporting frameworks for such disclosures by UK pension schemes: either the TPR scheme return for trust-based DB

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[5] '[Knowledge and understanding duty on board members]', TPR.
[6] See [IA response] to DWP call for evidence on 'Pension trustee skills, capability and culture'

schemes[7], or the new requirements for DC schemes[8]. The asset class breakdowns under both these sets of requirements are sufficiently granular and familiar to investment managers and consultants who, respectively provide and collate such data to UK pension schemes. Standardising data across the UK pensions market will help to keep the costs of data provision lower, to the benefit of the ultimate investors in these schemes, and, where applicable, those who fund them.

We note that the current LGPS Advisory Board reports include disclosure of investments in pooled vehicles (i.e. collective investment schemes). We would suggest that the new requirements should look through any collective investment vehicles to the underlying asset classes, as this is more useful data for asset allocation than whether or not the relevant assets are held in a pooled vehicle.

Reporting on net savings achieved as a result of investing via a fund's pool

While we understand the desire for reporting in this area, we think this is likely to be particularly challenging to report on for two reasons, depending on what the comparison point is for measuring savings:

- Comparing current investment costs against a baseline of 2015/16, when pooling began, is likely to be challenging due to a combination of changes in market pricing in subsequent years, as well as changes in fund asset allocation, which may mean that the investment cost base is very different today compared to what it was at the outset of pooling. This makes comparisons very difficult to make.
- If the comparison is the cost of investments via the pool today vs the cost of the same investments being made outside of the pool, the latter figure may be challenging, or even impossible to obtain, since by definition a fund will not have invested outside the pool.

We would encourage the government to reconsider whether the net savings from pooling is an appropriate metric to report. As highlighted earlier in this response, pooling brings a number of benefits in addition to cost savings, including greater investment sophistication and enhanced governance, which on their own justify the exercise.

The risk of a focus on cost above all other factors is that it can make it very difficult to allocate to asset classes that involve higher costs, an issue that has been seen very clearly in the UK DC pensions market. This is a significant risk at the very point that government is seeking to raise the LGPS's allocations to more expensive asset classes, including private assets.

Asset class level reporting and benchmarking

Monitoring asset class level performance over an appropriate timeframe is critical for the pools, as it is an important part of the ongoing assessment and oversight of the investment managers appointed to manage a mandate.

However, we do not see the benefits of asset class level performance reporting at the local authority fund level. What matters to funds (and scheme members) is performance of the total portfolio, in relation to some form of fund-specific liability benchmark, because it is

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[7] The current scheme return form can be found here.

[8] See 'The Occupational Pension Schemes (Administration, Investment, Charges and Governance) and Pensions Dashboards (Amendment) Regulations 2023' and accompanying statutory guidance.

the fund's liabilities that represent its' obligations and so the investment strategy should be geared to ensuring that schemes are well funded and that pension obligations can be met.

Public reporting of performance by local authorities should therefore be in relation to a fund-specific liability benchmark of the pension committee's own choosing and should be done over a longer-term basis e.g. a rolling three- or five-year basis, reflecting the long-term investment horizon of a DB fund.

Beyond that, it is problematic to compare performance across funds because funding levels, investment strategies – and therefore performance – could differ markedly. This is not reflective of relatively better, or worse, performance, but instead the specific investment decisions of a fund with a given funding level and maturity profile that is targeting a particular return for a chosen level of risk.

Comparing performance across funds could lead to returns being taken out of context and could lead to inappropriate investment decisions being made in an effort to boost short term returns. It may lead to herding of investment strategies where funds seek to minimize tracking error with respect to the uniform benchmark. This is especially likely to be the case if the benchmark is peer-based and based on annual returns.

Q6: Do you agree with the proposals for the Scheme Annual Report?

We agree with the aggregation of fund-level asset allocation data based on the standardised categories that funds report under. Taken together this will provide a helpful picture of LGPS-wide asset allocation.

<u>LGPS investments and levelling up</u>

Q8: Do you agree that funds should be able to invest through their own pool in another pool's investment vehicle?

Yes, in principle we agree that funds should be able to invest through their own pool into another pool's investment vehicle, where a particular strategy or asset class that a fund wishes to allocate to is not available via its own pool.

However, in permitting this there will be a number of issues for pools and funds to consider:

- 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 investment to take place.

Investment opportunities in private equity

Q11: 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?

We welcome the consultation's recognition that local authorities remain responsible for their investment strategies and that there is to be no mandated requirement to allocate to specific asset classes. It is important for the sustainable and cost-effective provision of pensions that scheme investment strategies can be developed without constraints on asset allocation.

While we understand and support the need for the LGPS to act as a greater provider of risk capital to the UK economy, we do have a number of concerns about the proposed ambition:

- Private equity is too narrow a definition. Capital could also be provided to companies through private credit, for example. It would therefore be better if the aspiration was amended to cover private asset classes more broadly.

- While the government's focus on the UK is entirely understandable, local authorities and pools should be able to allocate globally in order to deliver the best outcomes to scheme members. UK opportunities are unlikely to be sufficient in number and scale to be able to absorb the amount of capital seeking to be deployed by the LGPS and other investors.

The consequence of a narrow focus on UK private equity is the risk of asset price bubbles inflating if a large number of (LGPS) investors are seeking to invest in a relatively small pool of assets. This would increase the risk of overvalued investments and poorer outcomes for investors.

These risks can be mitigated by ensuring that the ambition applies more broadly to private assets on a global basis. As long as attractive private investment opportunities exist in the UK, this broader ambition should be sufficient to ensure LGPS capital finances UK opportunities.

With respect to the role of the government in helping create the conditions for the UK to be an attractive investment destination to long-term investors such as the LGPS and other pension schemes, we highlight the importance of policy certainty in creating a predictable and stable investment environment e.g. policy certainty on renewable energy, transport and other climate transition considerations; improvements to the planning regime to accelerate local development opportunities.

As a final comment, we note that private asset classes are more expensive to invest in due to the costs involved with the sourcing, structuring and ongoing management of these investments. Investors are aware of these higher costs and choose to invest in private assets for the enhanced return and diversification benefits they provide. However, it is likely that investing in these asset classes will increase the LGPS's overall investment costs and this is one reason why the benefits of pooling will need to be considered in terms beyond simple cost savings.