DF/23/100
Devon Pension Board
13th October 2023

LGPS Update

Report of the Director of Finance and Public Value

Please note that the following recommendations are subject to consideration and determination by the Committee before taking effect.

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1) Recommendation

That the Board be asked to:

(a) Note the developments affecting the LGPS

2) Introduction

2.1 This report is brought to the Pension Board to provide an update on the latest developments affecting the LGPS.

3) July 2023 Consultation

3.1 On the 10th July 2023, the Chancellor set out his Mansion House speech which included the proposed consultation on investment within the LGPS, the consultation being published the following day (with a closing date of 2 October 2023)

3.2 In his Speech, the Chancellor noted the desire to “accelerate the consolidation of pension assets by March 2025”, with proposals to increase transparency, cost savings and the scale of LGPS investment pools while noting that Investment Strategy remained a decision of the individual Funds.

3.3 The five areas considered within in the consultation are set out below:

• Proposals to accelerate and expand investment pooling, with the aim of increasing the pace of transition, in order to achieve further benefits, improved net returns, more effective governance, increased savings and access to more asset classes.

• A requirement for Funds to have a plan to invest up to 5% of assets to support levelling up in the UK. • To increase investment in high growth companies via unlisted equity.

• To propose amendments to the LGPS investment regulations which related to the use of investment consultants and including a requirement to set out strategic objectives for those consultants with a formal review every 3 years.

• To make a technical change to the definition of investments in the LGPS regulations in relation to partnership arrangements so they fall within the definition of investments.

3.4 The consultation was released on 11 July 2023 and contains a number of detailed proposals submitting questions on the proposed amendments and inviting responses. Officers drafted a response which was discussed at the Investment and Pension Fund committee on 15th September. The final response was submitted at the end of September and can be found attached to this report.

4) McCloud Regulations

4.1 On the 8 September, Government issued its response to the consultation 'McCloud remedy in the LGPS – supplementary issues and scheme regulations' which closed on 30 June 2023. This consultation covered proposals around aggregation, club transfers, flexible retirement, divorce, injury allowances, compensation, interest and excess teacher service and has been anticipated by Funds to confirm how the remedy would be implemented across affected members.

4.2 Overall, the response confirms that the proposals in the consultation will be implemented and where it is required, updated Government Actuary's Department guidance will be issued as soon as possible, in addition to an updated Public Sector Transfer Club memorandum. A national working group has been set up to consider the areas where guidance is needed, and the response sets out some of the areas where guidance will be statutory and where it will be non-statutory. Statutory guidance will be issued where it is necessary to have a consistent approach on areas not already achieved through regulations. This will include the prioritisation of McCloud cases and how to identify which members qualify for McCloud protection where there could be earlier service in another LGPS fund or another public service pension scheme. Other areas will have nonstatutory guidance, such as administrative guidance and complex case examples, and how to deal with flexible retirement cases. Where a need for guidance is identified, there will be a technical consultation with selected stakeholders representing those affected. There are still some areas where additional regulations are needed (particularly for dealing with excess teacher service) and a further consultation on these will follow in due course with selected stakeholders.

4.3 The only amendment to the original proposals is in the area of interest, where there is a small change to the way interest will be applied to additional Pension Commencement Lump Sums.

5) Abolition of the Lifetime Allowance

5.1 As part of a package of reforms announced in the Chancellor's March 2023 budget, the Pension Lifetime Allowance, designed to cap tax relief on pension saving, was to be abolished. Government is now seeking to clarify the tax treatment of pension savings and how limits will apply to pension and lump sums from April 2024. The proposals are beneficial to members who may be caught by the tax provisions as their payments will now be taxed on their relevant tax rate (as opposed to the higher rate), however has the potential to further increase the workloads for pension funds with the need to apply individual calculations to lump sum payments.

6) Conclusion

6.1 The Pension Board is asked to note the issues and developments of the LGPS outlined in the report.

Angie Sinclair
Director of Finance and Public Value

Electoral Divisions: All

Local Government Act 1972: List of background papers

Nil

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25 September 2023

Re: Consultation Document: Local Government Pension Scheme (England and Wales): Next Steps on Investments

Thank you for the opportunity to comment on the consultation document: Local Government Pension Scheme (England and Wales): Next Steps on Investments.

This consultation response is submitted on behalf of Devon County Council in its capacity as the Administering Authority for the Devon Pension Fund and has been approved by the Investment and Pension Fund Committee at its meeting on 15th September 2023.

The Devon Pension Fund is a shareholder and client of the Brunel Pension Partnership (Brunel). Brunel was set up in 2018 following the completion of a thorough business case approved by all ten of the partner funds. The business case set out the forecast savings that could be achieved over the longer term from the pooling proposals, and also the short-term costs that would be incurred in transitioning investment assets to the new arrangements. Brunel is now working well, and the Fund reached the point in 2022 when the cumulative savings achieved exceeded the initial costs of set up and transition. Therefore, we are now in the position of harvesting the savings achieved.

The Devon Fund has now transitioned 95% of its assets to Brunel. The remaining 5% of assets are held in closed ended private markets funds, which will return capital over time which will then be reinvested via Brunel.

Given that it took 4 years to break even, based on savings achieved versus transition costs incurred, and that we are now achieving significant savings each year, our over-arching concern is that the proposals should not result in another round of significant transition costs that negate the savings now being achieved as a result of the implementation of the original pooling proposals.

Answers to the specific questions posed are provided below:

Question 1

The Brunel pool is working well. 90% of client assets have now transitioned to the pool, the Devon Fund has transitioned 95% of our assets. We recognise that other pools have not all made the same level of progress, and our view is that the Government should focus on addressing the barriers that are preventing other pools from working effectively. Those pools, such as Brunel, who are working effectively should be allowed to continue with minimum disruption.

While the pool's assets are currently below £50 billion, there would be disadvantages in expanding the size of the pool:

- Brunel largely serves a defined geographic region, the South West, providing a level of local accountability that would be reduced if the pool covered a wider area.

- The regional basis of Brunel should help with setting up local investment portfolios to promote investment in the South West, in line with the Government's levelling up agenda. An expanded pool would change investment priorities in this regard.

- Brunel was set up as a partnership of like-minded LGPS funds. The involvement of a larger number of funds may reduce the like-mindedness of the partner funds which would result in governance issues, as have been experienced by other pools.

- As stated above, the Brunel pool has largely gone through the pain of transition and is now working effectively and benefiting from the cost savings resulting from pooling. It would be unhelpful to go through another round of transition costs in order to form a larger pool, which would undermine the savings that are now being delivered.

Therefore, we would urge the Government not to be too fixated on a particular number in terms of a pool's assets under management, but to consider a range of criteria in analysing how well the existing pools are performing and what action is required to support the delivery of excellent value for money and outstanding net performance. We would support greater collaboration between pools as an alternative to forced mergers between pools.

Question 2

The Devon Pension Fund has already transitioned all of its listed assets to Brunel, our LGPS pool, well in advance of the proposed March 2025 deadline.

Question 3

We agree with the statement that responsibility for setting the investment strategy should remain with the individual LGPS funds. It is therefore the pool's responsibility to implement the strategy of each of its client funds.

The original pooling proposal aimed to take manager selection away from the individual funds and make it the responsibility of the pool. We support the idea that if an LGPS fund wishes to invest in e.g. a core global equity portfolio, then the pool should provide such a portfolio and be responsible for selecting a manager or managers to manage that portfolio (or provide internal management). Where more than one manager is selected for a portfolio, then it should be for the pool to allocate funds between the managers on the same basis for each client, and it should not be permissible for the individual LGPS Fund to decide which of the managers it wishes to allocate funds to. The pool should not provide more than one core global equity portfolio with different managers for different portfolios which would then effectively enable individual LGPS funds to retain the ability to choose a manager.

The pool should, however, provide a range of equity portfolios with different risk and return characteristics, e.g. emerging market equities, smaller company equities, sustainable equities, choice of active/passive, in order to meet the requirements and implement the strategies of each client fund.

We do not believe it is the pool's role to act as investment consultants for client funds in determining their investment strategy.

<u>Question 4</u>

The Devon Fund is committed to ensuring Pension Committee members are adequately trained. We already produce an annual training plan and report on the training undertaken by committee members in the Fund Annual Report. We therefore support this proposal.

<u>Question 5</u>

We support the proposal for each fund to report in a consistent way against a set of broad asset class headings through their annual reports and statistical returns.

We would not support reporting against standard benchmarks. The choice of benchmark reflects the level of risk and target return required from an investment portfolio, which will be different depending on the investment strategy. A standard benchmark across all funds and/or pools would influence the investment strategy in an unhelpful way. If the objective is to compare the investment performance of funds, then that can be done through comparison of net returns, without the need to enforce standard benchmarks.

<u>Question 6</u>

We are happy with the proposals for the Scheme Annual Report.

<u>Question 7</u>

The Devon Fund already has significant investments in UK infrastructure. In addition, the Investment and Pension Fund Committee has recently agreed to allocate 3% of the Fund to a local impact portfolio. We believe that these investments would contribute to the Government's levelling up agenda and would be happy with the requirement to set these out in a plan and report on them through the Fund's Annual Report.

The aim of the local impact portfolio is to invest in Devon and the wider South West, recognising that there is a need locally to level up to more prosperous areas. Where possible, we will work with Brunel on our objectives, but we would urge that the Government recognise that when funds are looking at local investments there may be a requirement to work with fund managers outside the pool arrangements, as the pools will be focusing on a wider area and larger scale investments that may not allow for a more localised investment. Individual LGPS Funds will need to ensure that conflicts of interest are managed, but adopting an over-prescriptive approach to investing through the pool on such investments may risk undermining local aspirations and the achievement of the Government's agenda on levelling up.

Question 8

We believe that funds should be committed to one pool, but if that pool then decides that the best way to deliver the required investment is to invest in another pool's investment vehicle, then that should be permitted and encouraged.

Question 9

We would support the inclusion of the levelling up plan within each fund's Investment Strategy Statement, rather than as a separate policy.

Question 10

The Devon Fund will be happy to report on levelling up investments within our Annual Report. Pools will need to be able to produce the required data in respect of such investments made through the pool.

Question 11

The Devon Fund is a supporter of investing in private markets. Since February 2022, the Fund has had a medium term target allocation of 10% to infrastructure, 5% to private equity and 5% to private debt. The Investment and Pension Fund Committee has now agreed to reduce each of those allocations by 1% to create the 3% allocation to a local impact portfolio, as described in the answer to question 7, but the local investments would also be in the private markets space.

However, private equity is at the higher risk end of the potential investment solutions available to pension funds. The mandating of a set minimum percentage to be invested in private equity would be in conflict with the fiduciary duty to act in the best interests of fund members. While the Government may want to encourage the LGPS to invest more in private equity it must stop short of mandating such investment.

Previously, the Government has had an ambition for LGPS funds to invest 10% in infrastructure. It is unclear from the consultation document whether the definition of private equity includes unlisted infrastructure. If the 10% proposed allocation to private equity is additional to a 10% ambition for (mostly unlisted) infrastructure investments, that makes a 20% allocation to a high risk area of the market. This may be above the risk appetite for some funds.

Many funds also have an allocation to private debt, which would also support the Government's aspirations to support growing businesses. It would therefore be helpful for the Government to be clearer on whether the 10% objective is across private markets or a much narrower definition of private equity.

Another aspect that the Government needs to consider is that the requirements on unlisted companies with respect to ESG issues, and specifically on climate reporting, are currently lower than they are for listed companies. Given the Government's intention to require LGPS Funds to increase the extent of their climate related reporting, it may be more difficult to source the data they will need from an increased allocation to private equity.

The question asks about the barriers to investment in growth equity and venture capital. One barrier is the level of risk involved in such investments, which may mean they are not suitable for inclusion in a fund's investment strategy where they are looking to de-risk. As set out above, the Government should not seek to force LGPS funds to invest in an asset class where it does not fit with the fund's risk management approach.

A further barrier is the availability of appropriate investment opportunities. The Government needs to do more to encourage the provision of more transparent investment opportunities if it wants to encourage investment, at the appropriate level of risk and potential return.

<u>Question 12</u>

As set out above, the lack of availability of suitable investment opportunities can be a barrier to the LGPS investing in the UK. If working with the British Business Bank helps to overcome that barrier and results in an increased provision of suitable investment opportunities, with the appropriate level of risk and return expectation, then the Devon Fund would support that.

Fiduciary duty requires that LGPS funds will need to independently assess the suitability of any investment opportunities that come out of any collaborative approach and should only invest where they fit with the fund's risk parameters. The Government should not seek to mandate investment in any particular project.

<u>Question 13</u>

The Devon Fund supports setting strategic objectives for investment consultants.

<u>Question 14</u>

This appears to be a straight-forward tidying up amendment, so we support it.

<u>Question 15</u>

We do not consider that there are any particular groups who would either directly benefit or be disadvantaged by any of the proposals.

Yours Sincerely

Mark Gayler
Head of Investments