Lincolnshire COUNTY COUNCIL Working for a better future

By email to lgpensions@levellingup.gov.uk

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Dear Sir or Madam

LOCAL GOVERNMENT PENSION SCHEME: NEXT STEPS ON INVESTMENTS

Lincolnshire County Council (Lincolnshire) welcomes the opportunity to respond to this consultation on the supplementary issues and draft regulations in relation to the "Local Government Pension Scheme (LGPS): Next steps on investments".

Lincolnshire is the Administering Authority for the Lincolnshire Pension Fund (LPF) as part of the LGPS. The Fund has assets of over £3 billion and has approximately 260 employers.

We welcome this consultation on the future of the LGPS and believe it is an important contribution to how we can collectively build on some of the good practice that has evolved across the LGPS since 2016.

In 2018, LPF's jointly owned pooling company, Border to Coast Pensions Partnership Limited (Border to Coast), began managing investments on behalf of 11 Partner Funds. The Partner Funds came together with an agreed set of principles that continue to guide how we work together. As a partner Fund of Border to Coast we are delivering against Central Government's original pooling policy objectives:

- Over £40bn pooled through Border to Coast, with clear plans to increase this in the years to come;

- £65m of net cost savings had been delivered to 31 March 2023, with expectations to increase this to £340m by 2030 (for LPF, the cumulative savings net of setup, operating and transition costs at 31 March 2023 were £3.65); and

- Improved investment governance and professionalism through a regulated structure.

Border to Coast adds significant value to LPF above and beyond the original pooling objectives, particularly in relation to responsible investment. They have built a centre of expertise, taking the lead on behalf of Partner Funds on active stewardship on climate change and other issues, and working collaboratively with groups such as Climate Action 100+ to deliver real world change. The collective scale also increases our influence as an active steward in other areas – whether on executive pay, or on driving standards in Responsible Investment and ESG disclosure.

LPF has made significant strides since 2018, with all our listed assets now pooled (or under pooled management), with plans established for pooling our real estate assets.

That said, while significant progress has been made, evolution is not fixed. We recognise the need to review and adapt to reflect both our individual development and to meet the various dynamic challenges that may impact us in pursuit of paying pensions in an affordable and sustainable manner. Any evolution should be consistent with the guiding principle that it is the responsibility of LPF to agree an investment strategy consistent with our fiduciary obligation to meet the pension promise of our scheme members, while ensuring that contributions for scheme employers remain stable and affordable.

It is regrettable, given the importance of governance to the successful delivery of the Government's policy objectives in this consultation, that there has not been a response to the Scheme Advisory Board's (SAB) recommendations in relation to the Good Governance Project. Concluding this work would have addressed some of these objectives.

Please see our responses to the questions raised below:

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

The ecosystem in which the LGPS operates is changing and it is important to acknowledge and adjust to this, to ensure we can continue to collectively deliver for LGPS members. This includes the increasing regulatory and governance complexity and burden on individual Funds.

This challenge can be addressed through:

- Engaged and informed Pension Committees and Local Pension Boards, exhibiting an appropriate level of knowledge, understanding and professionalism. They should be supported by experienced officers, exclusively dedicated to the Pension Fund, with the right resources and support to develop, and manage the oversight of their investment strategies.

- Appropriately resourced pools, which can support the development and implementation of the investment strategies of their Partner Funds. As centres of expertise these pools can provide wider support for Partner Funds.

In operating any system, good governance is fundamental. This can cover a wide range of issues, but includes the establishment of clear divisions of responsibilities, robust oversight and simplified, flexible decision-making, including effective delegations to specialists trusted to exercise sound judgement over the long-term. The importance of this is often underestimated.

The "governance premium" is thought to be around 0.6% per annum additional return (and has been estimated as high as 1-2% p.a.). This can be evidenced[1] via asset owners with "good governance". This relates primarily to clear delegation of investment decision-making with strong oversight and scrutiny by the asset owner Pensions Committee. It is based on research over the last 20 years. We recognise that standards are variable, with smaller funds, in particular, less likely to rate themselves as highly on important measures of quality. While each fund and pool should consider their own governance frameworks, progress on the 'Good Governance' review will support the LGPS and progress would therefore be welcomed by all[2].

Scale can deliver significant benefits. A 2022 publication[3] by CEM looked at the case for scale for pension schemes. Its findings were that asset pooling led to lower staff costs per assets invested due to the ability to internalise certain investment capabilities, and to lower external management fees due to the negotiating strength that comes from the value of mandates being placed, negotiated by professional investors whose interests are fully aligned with the ultimate asset owners.

However, scale doesn't always deliver additional benefits; seeking scale without addressing the critical issues such as good governance, management of conflicts of interest, a common vision and culture (within the Pool and among Partner Funds), complexity of investment strategies, and client needs, can either inhibit, or damage, a pools ability to deliver.

Delivering the benefits of pooling can be challenging and requires an understanding at officer and elected member level of both the benefits and costs of compromise, and an ability to assess where such compromise does not have a material impact on the risk/return profile that the Partner Fund wishes to achieve.

In considering the LGPS ecosystem and ensuring that good outcomes are delivered it is important to recognise and manage the potential conflict of interests that both investment consultants and pools may have in providing investment advice to Funds.

There has been greater progress and success in pooling where Funds have worked constructively with their advisors, consultants and their pools. In this situation the benefits that come from pooling in both investment outcomes and reduced ongoing governance and advisory costs are considered.

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[1] Pension Policy Institute: "Defined Benefits: the role of governance"

[2] The PLSA research, "LGPS: Views from inside the scheme" states that three-quarters of respondents believe government and regulators should focus on good governance (74%).

[3] A case for scale, February 2022

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

We support the principle of transferring, or having a clear path to transition, assets to pools. Each funds' ISS should include a transition plan for assets to be transferred to the pools, as well as the composition and justification of any assets remaining outside the pool.

Partner Funds have already transferred most of their assets to Border to Coast. Further transfers are planned over the next few years. Each transfer event is predicated on the launch of an investment fund, the development of which typically takes six to twelve months including receiving approval by the FCA. There will be times when due to the complexity of the investment fund, such as property, this timescale may be longer. Resources to develop new funds are limited and imposing an arbitrary timescale could lead to hasty fund launches of sub-optimal investment funds.

We would welcome clarity and understanding on the position of legacy illiquid assets, particularly those in private markets. With fees already negotiated, and with typically no ability to adjust them post commitment, transferring these assets to the pool may simply incur new legal and tax costs. There may be occasions when the pools (where appropriate) can support Partner Funds on the oversight of legacy illiquid assets as they run-off.

For private market investments, where the pool does not provide the full managed service that existing managers provide (including full cash flow management), there may be additional time required for the pool to develop these capabilities, assuming they are able. Funds should be able to justify why any investments are not transferring within the expected timeframe.

We would also welcome clarity on 'passive' investments. In our current arrangements, we have jointly procured index funds in large, liquid and low-cost pools. These assets benefit from additional oversight from Border to Coast, and there is no obvious value for them to be replicated within the Pool. We believe that these investments should continue to be considered pooled ("assets under pool management").

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

Through Border to Coast we have developed a model of pooling which has successfully allowed us to meet the government's objectives for pooling. We support the approach set out in the consultation, which reflects how we have sought to pool. However, we would urge caution on being overly prescriptive in describing any model in guidance as this may stifle innovation and the ability of Partner Funds and pools to respond to changing circumstances.

Administering Authorities are responsible and accountable for their investment strategies. A pool such as Border to Coast could potentially play a significant role in supporting the development of, and being responsible for implementing, a Partner Fund's investment strategy. However, robust governance arrangements need to be in place to manage potential conflicts, and to ensure proper oversight and scrutiny by Partner Funds can take place.

When drafting guidance, due consideration should be given to investment strategies that meet needs of a diverse employer group. This could include employers with differing maturity characteristics that may benefit from different investment approaches to protect their position.

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

The key to a successful approach is ensuring decisions are made by the right people, with the right level of knowledge, at the right time.

It is important that there is local accountability for target returns, risk appetite, and investment beliefs that underpin the investment strategy to deliver cost effective and sustainable pensions.

As outlined in the consultation, and something we support, the role of a Pension Committee is to review and approve the investment strategy, and to provide oversight and scrutiny on how this is being executed. To be effective in this role, Committees will need to have in place appropriate delegation of functions to officers, who have sufficient experience and knowledge to support the Committee. In turn, officers and Committees can be supported by the centre of investment expertise that resides in the pool that they own, which is also responsible for the implementation and management of that Funds investment strategy.

The knowledge and understanding of Pensions Committees may be supported by independent advisors and consultants, who can play a key role in supporting the Committee in their responsibilities in the oversight and scrutiny of the investment strategy by the pool.

For Pension Committees, a key component to this is an effective training policy, which is reported against as part of clear delegation of functions between Committee and officers. This is something LPF manages in a structured way.

We recognise the difference in the current training requirements between Pension Committees and Local Pension Boards. We believe it is appropriate that the requirements for sitting on a Pension Committee should at least match that of membership of a Local Pension Board.

Given both the significant training requirements, and the responsibilities of membership of a Pension Committee, we believe it is appropriate that Pension Committee members should be appropriately remunerated.

We believe Government proposals in relation to the interaction of pools and funds, and the training of pension committee members, should be addressed as part of a holistic response to the Good Governance Project report completed by the Scheme Advisory Board to ensure changes take place within a framework focused on delivering the best outcomes for LGPS members.

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

We support the proposal to have standard reporting requirements with clear and consistent definitions. We would welcome this is being progressed as part of the Good Governance project. We would also welcome a complete review of the regulations to simplify and streamline processes.

While support reporting net savings, this needs greater consideration, specifically "against what?". In calculating our savings, we are comparing our current position with data from 2015/16, which is not reflect the market pricing we see today. This information has become dated and is arguably irrelevant. Equally, a focus on cost may also drive unintended consequences, particularly given the desire from the Government to increase investment in more expensive asset classes, such as private markets. As the pooling journey continues, it may be appropriate to use other reporting mechanisms.

We have significant concerns on the proposals to produce standard reporting on investment returns. Each individual fund has its own investment strategy and risk appetite. Even within a single pool, although two funds may superficially have similar investment strategies, they may be seeking to deliver significantly different outcomes. There is a danger that returns reported against an inappropriate benchmark are taken out of context and could lead to poor investment decisions being made.

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

We support clear and consistent reporting by the Scheme Advisory Board, provided the Board is sufficiently resourced to undertake the work and it is undertaken in such a way as to minimise the data collection burden on funds.

We also note the broader issue of increased reporting for the LGPS. The research in "LGPS: Views from inside the scheme" found that over half (54%) of respondents feel that the legislation/regulatory requirements are already too complex to execute, while two in five (43%) continue to feel legislation/ regulatory requirements hinder them from doing their job effectively.

This is not to diminish the fundamental role of transparency and reporting. This is essential to ensure accountability, and to drive best practice across the LGPS. However, simplicity is key. Partly driven by the scale and complexity in current reporting requirements, we understand a recent review by SAB suggested that nearly a third of LGPS funds were not meeting their annual report disclosure requirements.

Simply adding additional reporting requirements not only adds cost, but there is a significant negative impact for the intended audience of the scheme members due to the volume and complexity of information being published. We believe that the impact assessment of changes in guidance, in terms of cost, transparency, and in the ability of readers to interpret what is shared, should be taken in the context of the ongoing review of LGPS reporting requirements being undertaken by the Scheme Advisory Board.

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

Although we do not disagree with the definition outlined in the consultation, it should be stressed that levelling up investments should be consistent with the investment strategies of Funds.

Through Border to Coast, a new private markets strategy, 'UK Opportunities'[4] is being developed. Set to launch in April 2024, we believe this could in future provide LPF with opportunities to invest in the regions across the UK, including venture and growth capital, should it fit in with the investment strategy agreed by the Pensions Committee. This would ultimately support the policy intent outlined in the Levelling Up white paper.

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

Collaboration has been, and should continue to be, a hallmark of strength in the LGPS. If a pool is unable to effectively develop and manage an investment proposition, there may be merit in sourcing this capability through another LGPS pool. However, it needs to be recognised that there are several implications that need to be fully considered and risks mitigated. These include issues such as:

- Proposition development – the Border to Coast propositions are designed with, and for, 11 Partner Funds who are both shareholders and customers. Care will be required should external pool customers wish to invest in them or evolve existing propositions. The existing governance structures and processes will need to be reviewed to overcome this challenge.

- Niche strategies – certain investments may have capacity issues. For example, despite significant demand, the initial Climate Opportunities strategy at Border to Coast was capped at £1.35bn, which reflected the availability of suitable market opportunities. The demand from Partner Funds was significantly above this figure. Care will be required in balancing the needs of shareholder customers vs external pool customers for capacity constrained investments.

- Cost model – as shareholders, existing customers principally manage risk through Border to Coast's regulatory capital. Different arrangements would need to be developed for non-shareholder external pool customers.

- Managing demand – in owning and building Border to Coast, there has been a structured approach to its growth, building capacity and capability to reflect Partner

[4] https://www.bordertocoast.org.uk/news-insights/border-to-coast-marks-five-years-of-delivery/

Funds long term needs. This is likely to be absent with non-shareholder customers and, in accepting external customers, there is a risk of managing inflows and outflows of capital. This could destabilise the ability to plan the required capacity in various functions of the business. There are also similar considerations regarding management of liquidity in certain propositions.

Management of additional customers will require careful consideration, particularly noting the potential additional layer of due diligence costs that will be required as a regulated asset manager investing into another regulated asset manager's vehicle.

Nonetheless, if these issues are overcome, it could be easier to manage this on a pool-to-pool basis, rather than an individual fund-to-pool basis.

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

The objective of LPF is to generate the appropriate risk adjusted returns to ensure we can pay pensions as and when they fall due, and set employer contribution requirements in an affordable and sustainable manner. Where ancillary objectives can be co-delivered without impacting these returns or increasing risk, such as those outlined in the Levelling Up White Paper, this is to be welcomed. We believe that Levelling Up, effectively delivered, has the potential to create growth; including creation of jobs, drive productivity, improve people's quality of life and better health and wellbeing outcomes.

However, LGPS assets are invested to deliver appropriate risk adjusted returns and should not be used to implement any Central Government policy objective – no matter how laudable they may be.

We welcome the recognition in the consultation that each Fund is responsible for setting their investment strategy, designed to deliver the appropriate risk adjusted returns they require.

Any investment strategy and associated reporting on Levelling Up needs to be through the principal asset classes (e.g. Real Estate, Private Equity, Infrastructure, Private Credit, etc). This ensures that the risk adjusted returns are considered on the same basis. This can be reported via a Fund's ISS.

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

We are comfortable with the proposals, albeit we note that this again expands the reporting and regulatory requirements on Funds, which will have resource implications.

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

Administering Authorities remain responsible for their investment strategies. As open defined benefit pension schemes, it is essential that we adopt appropriate diverse investment strategies designed to balance risk and return to ensure the LGPS remains affordable with stable employer contributions.

As part of this approach, private markets can play an important role. An allocation to private markets (including property) of 27% is already included in our investment strategy.

We note the reference to private equity and technology. This is a very narrow part of the market. Early-stage growth, especially that focused on technology, is relatively high risk. For investors who have not made meaningful or any previous commitments to private capital more broadly, this is a challenging entry point and risks volatile returns or losses, which would likely discourage future investment in private markets.

A broader definition, covering 'private capital' allows investors to build private market risk appetites which suits their own circumstances, rather than pushing everyone to a more narrowly defined and therefore potentially crowded part of the market with more volatile returns.

We believe we already substantially meet the aspiration to invest 10% of our assets in these areas. Recognising our current extensive UK investment exposure across our asset allocation, the opportunity set should be global in nature.

The most effective way to encourage any investment in the UK is the provision of a stable investing environment through policy certainty. If the LGPS and private capital is being asked to make large, long-term, capital investments, the Government needs to offer corresponding long-term guarantees and the necessary policy certainty to protect these potential investors. Examples include policy certainty on renewable energy, transport and other climate transition considerations; improvements to the planning regime to accelerate development opportunities and to enable clearer partnership opportunities with Local Authorities; and the development of structures, perhaps with the support of organisations such as the British Business Bank (BBB) and the UK Infrastructure Bank (UKIB) to enable risk sharing and return visibility.

While there is understandably a continued focus on costs, it must be recognised that private markets are a more complex and expensive asset class.

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

There are a range of potential partners that can support the LGPS pools to deliver growth capital in the UK, BBB and the UKIB being two examples.

Given their state ownership and strategic focus to 'crowd in' other investors, these institutions may be well placed to support the LGPS pools source and commit to ventures that meet their normal investment criteria.

We do note that one of the key objectives of LGPS pooling was to reduce the fee burden paid by pension funds. In in a private market context, this included reducing the reliance on fund of fund structures which introduce an additional layer of fees and carry (profit share) expense. As such, any vehicle should be offered on a cost only basis if the intention is to encourage greater participation in this part of the market. An additional layer of fees would deter potential investors. BBB will be investing balance sheet capital into all investments, so a successful investment policy would deliver profitability for them without this fee income.

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

LPF already sets strategic objectives for investment consultants and we welcome its consistent application across the LGPS.

Question 14: Do you agree with the proposed amendment to the definition of investments?

Yes.

Question 15: Do you consider that there are any particular groups with protected characteristics who would either benefit or be disadvantaged by any of the proposals? If so please provide relevant data or evidence.

No.

Yours faithfully

Jo Kempton
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