

Investment Regulations Update

Summary

The Government has published two documents concerning the management of Local Authority Pension Scheme investments. The related to:

- I. Consultation on revisions to the investment regulations and new Government powers of intervention.
- II. Timetable for submission and content of plans for pooling investments and criteria for judging acceptability of pooling proposal submitted.

Both documents have an initial response date of 19 February. The pooling criteria require an initial response in February and final proposals by 15 July 2015. It is not necessary to respond to the draft investment regulations.

The changes to the investment regulations are welcome. The proposal is to replace specified limits with a prudent person approach based around an Investment Strategy Statement that replaced the Statement of Investment Principles.

The proposed intervention power will give the government the ability to instruct Administering Authorities on how to invest their pension fund and to appoint persons to do so. It appears mainly aimed at enforcing pooling but could be used to increase allocations to infrastructure and even to change arrangement for non investment issues.

The Government is seeking to establish around six investment pools of £25 billion each. Local authorities are required to submit plans to participate in pooled investments. The arrangements for the London CIV are consistent with the pooling criteria. The pooling plans require considerable detail (appendix 3) and even with the help of the CIV will take time to prepare.

Further details on each document are given below.

Revisions to Investment Regulations

The consultation is to replace Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. The replacement regulations require the development of a prudent investment strategy.

The use of the proposed intervention powers is aimed at ensuring “that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.”

The consultation asks:

Whether the investment guidelines provide sufficient flexibility.

Whether the Secretary of State’s powers of intervention are appropriate.

Investment Regulations

The proposal is to remove the existing schedule of limitations on investments.

Instead authorities will be expected to take a prudential approach, demonstrating that they have given consideration to the suitability of different types of investment, have ensured an appropriately diverse portfolio of assets and have ensured an appropriate approach to managing risk.

The Statement of Investment Principles is dropped and instead there will be an investment strategy statement. This will cover:

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

Apart from the change of name the ISS will be substantially similar to the SIP. It may well be shorter will some detail e.g. managers and benchmarks omitted. Of course, the regulations state the minimum inclusions and more can be added.

If the draft regulations are effective from April 2016 as expected, the ISS will be required by 1 October 2016. The current investment restrictions will apply until the ISS is approved.

Other details removed from the regulations include frequency of monitoring investment managers, specified terms for appointing fund managers and the need to report compliance with the Myners principles. There remains a statutory requirement to take and act on proper advice.

Exclusionary Policies

The Government has said that it is inappropriate to use pensions and procurement policies to pursue boycotts, divestments and sanctions against foreign nations and the UK defence industry other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government. In this respect **Guidance on how ESG policies should reflect UK foreign policy will be published ahead of the new Regulations coming into force.** This will make clear to authorities that in formulating these policies their predominant concern should be the pursuit of a financial return on their investments, including over the longer term, and that, reflecting the position set out in the paragraph above, they should not pursue policies which run contrary to UK foreign policy.

Quite what the impact will be of the above statement and whether it impacts beyond foreign and defensive industries will depend on the wording of the guidance. The consultation also included a further paragraph on the application of investment powers, by restating guidance given in 1983:

“A body charged with the administration for definite purposes of funds contributed in whole or in part by persons other than members of that body owes, in my view, a duty to those latter persons to conduct that administration in a fairly business-like manner with reasonable care, skill and caution, and with a due and alert regard to the interest of those contributors who are not members of the body. Towards these latter persons, the body stands somewhat in the position of trustees or managers of the property of others.”

Those in local government responsible for making investment decisions must also act in accordance with ordinary public law principles, in particular, the ordinary public law principles of reasonableness. They risk challenge if a decision they make is so unreasonable that no reasonable person acting reasonably could have made it.

In essence the requirement is that any policies in selecting investment must have regard to the implications for those who contribute and benefit from the fund.

Government Powers of Intervention

To ensure that the new flexible investment regulations are used 'appropriately', the consultation also proposes to introduce a power to intervene in the investment function of an administering authority if the Secretary of State believes that a Council has not had regard to guidance and regulations.

Intervention will require evidence that a Council is ignoring information on best practice, for example, by not responding to advice provided by the scheme advisory board to local pension boards, is not following the investment regulations or has not had regard to guidance e.g. has not participated in investment pooling to the extent required. In addition the use of inappropriate actuarial valuation methods may give rise to intervention.

In applying the powers, if Government suspected there was an issue, they would carry out a review, probably using external 'experts' and invite the Council to participate and would be required to provide data. Following this review the Government would determine the extent of the intervention required. The forms of intervention are broad and could include:

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

Any council presented with an intervention plan would be given time to comment and presumably to propose alternative arrangements e.g. take action to address the government's concerns. The period of intervention will be set, monitored and at some point ended. All costs will be paid from the pension fund.

These powers have never been exercised before by the Government and go beyond those of the Pensions Regulator in the private sector. Although assumed to relate mainly to pooling, their application could be much wider, including non investment issues if these are seen to be below best practice. As the process involves a number of steps, any Administering Authority will have the time to make proposals to address the issues raised.

Conclusion / Impact on Haringey

The relaxation of the investment restrictions are mostly technical and will not require change to the investment strategy. They do offer some additional flexibility but that was not a great concern for Haringey.

The intervention powers are aimed at compulsory pooling, but with much wider application. Haringey is already committed to the CIV in respect of passive equities. We may be required to pool other asset classes, including changing investment managers even if we deemed the new arrangements are inferior.

Criteria on Pooling

Each Administering authority is required to submit proposals for pooling which the Government will assess against the criteria in this document. The Government is looking for up to six funds, each with assets of at least £25bn, which are able to invest in infrastructure and drive local growth.

It will be for authorities to suggest how their pooling arrangements will be constituted and will operate. In developing proposals, they should have regard to each of the four criteria, which are:

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

Additional detail is contained in the consultation as to content of each administering authority's response (see appendix 3). Considerable supporting detail is required e.g. 15 year estimate of saving. Although the London CIV will be able to provide some of the response detail for the London Boroughs, we will need to consider our own asset allocation and what might remain outside the CIV and for how long. In addition, we will be required to report on investment governance structures that retain democratic accountability.

Significant comments included in the criteria include:

- Active fund management should only be used where it can be shown to deliver value.
- Response to discuss current and future capacity for direct infrastructure (outside of funds).

An initial response is required by 19 February 2016. This comprises a commitment to pooling and a description of their progress towards formalising their arrangements with other authorities. Authorities can choose whether to make individual or joint submissions, or both, at this first stage.

Refined and completed submissions are expected by 15 July 2016, which fully address the criteria in this document.

The submission may include arguments for maintaining any assets outside of pools, acknowledging that some illiquid asset classes e.g. private equity, may take time to pool. The Government expects that asset transfers will seek to minimise transaction costs.

Each authority will receive a response from the Government setting out the extent to which the proposal meets the pooling criteria and any areas inadequately addressed and enter into a dialogue on any deficiencies. Should the Government not be satisfied after discussion it may use its powers of intervention. Prior to pooling administering authorities must continue to manage their strategies and investments. The Government expects that asset transfers to pools will commence by April 2018. The London CIV is well ahead of this timetable.

Next Steps

A discussion on the two consultations will be included in the agenda for the January 2016 meetings together with draft responses.

Investment Regulations - Consultation Questions

1. Does the proposed deregulation achieve the intended policy aim of removing any unnecessary regulation while still ensuring that authorities' investments are made prudently and having taken advice?
2. Are there any specific issues that should be reinstated? Please explain why.
3. Is six months the appropriate period for the transitional arrangements to remain in place?
4. Should the regulation be explicit that derivatives should only be used as a risk management tool? Are there any other circumstances in which the use of derivatives would be appropriate?
5. Are there any other sources of evidence that the Secretary of State might draw on to establish whether an intervention is required?
6. Does the intervention allow authorities sufficient scope and time to present evidence in favour of their existing arrangements when either determining an intervention in the first place, or reviewing whether one should remain in place?
7. Does the proposed approach allow the Secretary of State sufficient flexibility to ensure that he is able to introduce a proportionate intervention?
8. Do the proposals meet the objectives of the policy, which are to allow the Secretary of State to make a proportionate intervention in the investment function of an administering authority if it has not had regard to best practice, guidance or regulation?

Detail to be contained within Pooling Response

The full criteria expected to be contained within each Administering Authorities Pooling response is set out below:

(a) **Asset pool(s) that achieve the benefits of scale:** The 90 administering authorities in England and Wales should collaborate to establish, and invest through asset pools, each with at least £25bn of Scheme assets. The proposals should describe these pools, explain how each administering authority's assets will be allocated among the pools, describe the scale benefits that these arrangements are expected to deliver and explain how those benefits will be realised, measured and reported. Authorities should explain:

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

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

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

Authorities should also revisit their internal processes to ensure efficient and effective decision making and risk management, while maintaining appropriate democratic accountability. Authorities should explain:

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

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

C. Reduced costs and excellent value for money: In addition to the fees paid for investment, there are further hidden costs that are difficult to ascertain and so are rarely reported in most pension fund accounts. To identify savings, authorities are expected to take the lead in this area and report the costs they incur more transparently. Proposals should explain how the pool(s) will deliver substantial savings in investment fees, both in the near term and over the next 15 years, while at least maintaining overall investment performance.

Active fund management should only be used where it can be shown to deliver value for money, and authorities should report how fees and net performance in each listed asset class compare to a passive index. In addition authorities should consider setting targets for active managers which are focused on achieving risk-adjusted returns over an appropriate long term time period, rather than solely focusing on short term performance comparisons.

As part of their proposals, authorities should provide:

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

D. An improved capacity to invest in infrastructure: Only a very small proportion of Local Government Pension Scheme assets are currently invested in infrastructure; pooling of assets may facilitate greater investment in this area. Proposals should explain how infrastructure will feature in authorities' investment strategies and how the pooling arrangements can improve the capacity and capability to invest in this asset class. Authorities should explain:

- The proportion of their fund currently allocated to infrastructure, both directly and through funds, or "fund of funds".
- How they might develop or acquire the capacity and capability to assess infrastructure projects, and reduce costs by managing any subsequent investments directly through the pool(s), rather than existing fund, or "fund of funds" arrangements.
- The proportion of their fund they intend to invest in infrastructure, and their ambition in this area going forward, as well as how they have arrived at that amount.
- for each pool, a joint proposal from participating authorities setting out the pooling arrangement in detail. For example, this may cover the governance structures, decision-making processes and implementation timetable; and
- for each authority, an individual return detailing the authority's commitment to, and expectations of, the pool(s). This should include their profile of costs and savings, the transition profile for their assets, and the rationale for any assets they intend to hold outside of the pools in the long term.