HOUSE OF COMMONS LIBRARY

BRIEFING PAPER

Number CBP-77343, 20 October 2016

Debate on e-petition on LGPS investment regulations

By Djuna Thurley

1. The petition

A petition calling for a debate on *the Local Government Pension Scheme (Investment) Regulations* got 105,771 signatures. It said:

> 5 million people rely on the LGPS to pay their pensions. Government wants powers over LGPS investment funds, but they could gamble away members' money on infrastructure projects. This is not allowed in any other UK scheme, including the MPs'. The LGPS must be invested in members' best interests. Parliament must debate this issue and make the government accountable for these powers of intervention as any such direction may breach the law. Specifically Article 18 paragraph 3 of the EU Directive 41/2003 Institutions for Occupational Retire Provision: "Member States shall not require institutions located in their territory to invest in particular categories of assets."

The Government's response to the petition was that:

> LGPS investment decisions will remain matters for local authorities, but councils should compare their investments in infrastructure against the example set by leading global pension fund investors.
>
> Councils must invest local government pension scheme funds in the best interests of scheme members. The Government has no intention of setting targets for infrastructure investment or removing the right of individual pension fund authorities to make their own decisions about strategic asset allocation.
>
> However, the pooling scheme assets announced at the July 2015 Budget will improve their capacity to invest in infrastructure, as well as achieving significant cost savings, while maintaining returns.
>
> We have recently consulted on proposals to grant the Secretary of State a power of intervention which would further protect members' and taxpayers' interests. We expect that the power to intervene would be used exceptionally when there was clear evidence that a pension fund authority was not acting reasonably and lawfully, The Government is currently considering the responses to the consultation (Ibid).

The Petitions Committee agreed that there should be a debate on this petition, which has been scheduled for Monday 24 October 2016.

The *Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (SI 2016/946)* were laid before the House on 23 September, to come into force on 1 November 2016. They apply to England and Wales only.

2. Background

The LGPS advisory board states that:

> Across the LGPS in England and Wales the scheme holds £217bn of assets (2014/15 figure). These assets are currently held in 91 local pension funds and are used to pay the pensions of former members of the scheme and their dependants. The LGPS is one of the largest funded pension schemes in Europe.[1]

2.1 The legal framework

Although the rules are set nationally by the Secretary of State, it is administered at local level by 'administering authorities', which broadly correspond to county councils and London Boroughs. These administering authorities are responsible for managing scheme investments, within the statutory framework.[2] The Local Government Association (LGA) explains that this means decisions are "taken by democratically elected local councillors working within the restraints of local authority budgets."[3]

2.2 Factors taken into account in investment decisions

When making decisions on investment, the primary responsibilities of administering authorities are to deliver the returns needed to pay scheme members' pensions, and to protect local taxpayers and employers from high pension costs.[4] In this context, there have been questions about the extent to which investments can be made with other objectives in mind – for example, a desire to invest in infrastructure or avoid certain investments on ethical grounds. Legal advice published by the LGA in April 2014 said that the power of investment must be exercised for investment purposes and not for wider purposes. However, as long as this remained true, the precise choice of investment could be influenced by wider considerations.[5]

2.3 CLG consultations

In recent years, CLG has been looking at ways of achieving economies of scale in LGPS funds – with the primary aim of improving returns and reducing deficits but also to enable greater capacity to be developed for investment in infrastructure. This included consulting on ways to improve collaboration between funds.[6]

In the summer 2015 Budget the Government said it would invite local authorities to come forward with proposals to pool investments in order to reduce costs. It would consult on detailed criteria and on backstop legislation to ensure that authorities that did not come forward with "sufficiently ambitious proposals" were required to pool investments.[7]

In November 2015, the Department for Communities and Local Government published a consultation on proposals to revoke and replace the LGPS Investment Regulations for England and Wales. The consultation laid out three main areas of reform:

---

1 LGPS advisory board; Q and A for LGPS members. Investment reform, August 2016
2 Ibid, para 1.5
3 LGA submission to the Independent Public Service Pensions Commission, December 2010, p6
4 CLG. LGPS: investment in partnershios consultation, November 2012, para 1.1
5 LGPS Advisory Board, Advice on Fiduciary Duty etc, April 2014
6 CLG, Call for evidence on the future structure of the Local Government Pension Scheme, June 2013 and CLG, Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies, May 2014
7 HM Treasury, Summer 2015 Budget, HC 264, July 2015, para 2.19

- Removing some of the existing prescribed means of securing a diversified investment strategy and instead placing the onus on authorities to determine the balance of their investments and take account of risk.
- The introduction of safeguards to ensure that the more flexible legislation proposed is used appropriately and that the guidance on pooling of assets is adhered to. This includes a suggested power to intervene in the investment function of an administering authority when necessary.
- The introduction of statutory guidance to assist administering authorities prepare for the new Investment Strategy Statements, including specific guidance on the extent to which non-financial factors should be taken into account when making investment decisions and how these should reflect UK foreign policy.[8]

Criteria published alongside the consultation, made clear the Government's expectation for ambitious proposals for pooling. The Government proposed giving the Secretary of State power to intervene where authorities did not take advantage of benefits of scale or adhere to guidance. Intervention could include: directing an authority to develop some or all of its assets in a particular way or requiring the investment functions to be exercised by the Secretary of State.[9]

How will pooling help investment in infrastructure?

A briefing by the LGPS advisory board explains:

> The Government commissioned research which indicates that significant savings can be delivered by the creation of around six investment pools, each with assets of at least £25bn. Each LGPS administering authority will be obliged to join, or help create, an investment pool with other LGPS administering authorities. Savings will be achieved through economies of scale and increased bargaining power; investment costs will be reduced along with other costs for all types of investment used in the pool.
>
> The Government would also like the LGPS to have the capacity and capability to be able to invest in infrastructure e.g. railway, road or other transport facilities or housing supply. Currently only a very small proportion of LGPS assets are invested in infrastructure, it is hoped that the creation of investment pools will make it easier for LGPS funds to invest in infrastructure due to their increased scale. (Q&A for LGPS members – investment reform).

In January 2016, a group of local authorities published the Findings of Project Pool. It said pooling had the advantage of achieving cost savings and other scale benefits, including a 'governance dividend'. These objectives could best be met by establishing multi-asset pools:

> For most assets currently held, namely actively-managed listed equities and bonds, these pools will be of sufficient size to deliver the majority of scale benefits (including cost savings and employing enough managers for diversification but few enough to avoid index returns) while still being of a size that individual funds can participate meaningfully in the pool's governance.

Investment in infrastructure could be facilitated by making suitable investment vehicles available to these multi-asset pools:

> **LGPS wide investment vehicles available to all pools ("MAPs Plus"):** For a number of asset types, greater benefits may be available by LGPS-wide collaboration. For example, an infrastructure investment platform or a national procurement framework of passive investment managers could be set up alongside the MAPs and be accessible to all of them. […]

[8] CLG, Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009: consultation, November 2015
[9] Ibid para 4.7

> **Access to infrastructure**: The infrastructure assets that historically have been most attractive to pension funds like the LGPS are established projects delivering steady income streams that rise with price inflation (since pension payments from the fund increase with inflation). There has also been some demand for some higher risk-return assets, but allocations will likely be lower. Improved access and lower cost is most likely to be achieved through a national platform accessible to all of the Multi-asset Pools (MAPs). [Findings of Project POOL, Summary report, January 2016]

In Budget 2016, the Government said it would work to establish a new LGPS infrastructure investment platform:

> 1.284 The government has received ambitious proposals from Local Government Pension Scheme administering authorities to establish a small number of British Wealth Funds across the country by combining their assets into much larger investment pools. These pools will deliver annual savings of at least £200-300 million, and we will work with administering authorities to establish a new Local Government Pension Scheme infrastructure investment platform, in line with their proposals, to boost infrastructure investment.

2.4 LGPS Investment Regulations 2016

The *Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016 (SI 2016/946)* were laid before the House on 23 September, to come into force on 1 November 2016. The Explanatory Memorandum explains the purpose:

> 2.1 The regulations make provision in relation to the management and investment of pension funds held by administering authorities required to maintain such funds by the *Local Government Pension Scheme Regulations 2013*. They revoke and replace the *Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009*.
>
> 2.2 Specific provision is made for administering authorities to publish an investment strategy in accordance with guidance issued by the Secretary of State and for the Secretary of State to issue a direction to any authority which fails to act in accordance with its statutory obligations or guidance issued under Regulation 7.

Regulation 7 places an obligation on administering authorities to consult on and publish an Investment Strategy Statement, which must be in accordance with guidance from the Secretary of State. The Explanatory Memorandum states:

> The statement must demonstrate that investments will be suitably diversified and should outline the administering authority's maximum allocations for different asset classes, as well as their approach to risk and responsible investing. Separate guidance from the Secretary of State will clarify how the Government's announcement on boycotts, sanctions and divestments should be taken into account when investment decisions are taken. (para 7.9)

Regulation 7 provides that:

> (2) The authority's investment strategy must include—
>
> > (a) a requirement to invest fund money in a wide variety of investments;
> >
> > (b) the authority's assessment of the suitability of particular investments and types of investments;
> >
> > (c) the authority's approach to risk, including the ways in which risks are to be assessed and managed;
> >
> > (d) the authority's approach to pooling investments, including the use of collective investment vehicles and shared services;

> (e) the authority's policy on how social, environmental and corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and
>
> (f) the authority's policy on the exercise of the rights (including voting rights) attaching to investments.
>
> (3) The authority's investment strategy must set out the maximum percentage of the total value of all investments of fund money that it will invest in particular investments or classes of investment.

Regulation 8 provides the power of intervention. The Explanatory Memorandum states:

> 7.10 Regulation 8 provides the Secretary of State with the power to intervene in the investment function of an administering authority if he is satisfied that the authority is failing to act in accordance with the regulations and guidance. The regulation also enables the Secretary of State to initiate enquiries if an intervention is warranted and must consult the authority concerned. The Secretary of State can intervene by directing the authority to undertake a broad range of actions to remedy the situation.

It enables the Secretary of State to make directions if satisfied that an authority is failing to act in accordance with guidance under regulation 7 (1). Directions may require all or any of the following:

> (a) that the authority make such changes to its investment strategy under regulation 7 as the Secretary of State considers appropriate, within such period of time as is specified in the direction;
>
> (b) that the authority invest such assets or descriptions of assets as are specified in the direction in such manner as is specified in the direction;
>
> (c) that the investment functions of the authority under these Regulations and under the 2013 Regulations be exercised by the Secretary of State or a person nominated by the Secretary of State for a period specified in the direction or for so long as the Secretary of State considers appropriate;
>
> (d) that the authority comply with any instructions of the Secretary of State or the Secretary of State's nominee in relation to the exercise of its investment functions under these Regulations and the 2013 Regulations and provide such assistance as the Secretary of State or the Secretary of State's nominee may require for the purpose of exercising those functions.
>
> (3) Before making a decision whether to issue a direction under this regulation, and as to the contents of any direction, the Secretary of State must consult the authority concerned.

The guidance on preparing and maintaining an investment strategy statement was published on 15 September 2016. It states that administering authorities "must commit to a suitable pool to achieve benefits of scale":

> **Regulation 7(2)(d) - The approach to pooling investments, including the use of collective investment vehicles and shared services**
>
> All authorities must commit to a suitable pool to achieve benefits of scale. Administering authorities must confirm their chosen investment pool meets the investment reform and criteria published in November 2015, or to the extent that it does not, that Government is content for it to continue. Any change which results in failure to meet the criteria must be reported by the administering authority, and/or pool, to the Secretary of State and the Scheme Advisory Board. Administering authorities should set out their approach to pooling and the proportion of assets that will be invested through the pool. This must include the structure and governance arrangements and the mechanisms by which the authority can hold the pool to account. Where services are shared or jointly procured, the administering authority must set out the rationale underpinning this and the cost benefit of this, as opposed to pooling. Administering authorities must provide a summary of assets to be held outside of the pool, and how this demonstrates value for money. The progress of

> asset transfers to the pool must be reported annually against implementation plans and submitted to the Scheme Advisory Board. Where it is possible that an asset could be pooled in the future, authorities must set a date for review and criteria that need to be met before the asset will be pooled.[10]

Concerns

UNISON argues that "investment decisions should be made by the funds and their members, not ministers."[11] It broadly supports the pooling process but is concerned that the regulations provide for "unprecedented powers of intervention":

> UNISON supports the pooling process but with qualifications, there should be trade union nominated scheme member representatives appointed to the pool governance structures. There must be a discussion with UNISON on how the financial benefits of pooling will be shared.
>
> These pools of assets, known as Collective Investment Vehicles will be expected to be cost-transparent, reduce the costs of investing, and invest more in infrastructure. UNISON supports the cost reductions and income improvements but the law requires pension funds to invest in the best interests of scheme members, therefore infrastructure investing must be in scheme members interest not the governments. The requirement for a full cost analysis of all of the LGPS funds is an endorsement of UNISON's consistent demands over the last five years for transparency of costs.
>
> The government consulted on a new set of investment regulations to support the pooling initiative. The regulations include unprecedented powers of intervention for the Government into the investment policies of the scheme's funds.[12]

In its response to the draft regulations, the LGA expressed concern that the extent of the powers for the Secretary of State to intervene were too broad:

> The extent of the powers given to the SoS are very broad and therefore provide more than sufficient flexibility. LGA's concern is that regulation 8(2)(a) ('that the authority make such changes to its investment strategy under regulation 7 as the Secretary of State considers appropriate, within a period of time specified in the direction') is too broad. Use of this regulation could put the SoS in a position of personally directing the strategic investment decisions (including the allocation of assets) for a particular LGPS fund. This could potentially open the SoS to challenge under EU restrictions on government intervention in pension fund investment, particularly if such directions proved to be ineffective.[…] A further means of minimising any risk of challenge would be to ensure that both Houses are aware of and comfortable with these proposals by passing these regulations through the positive procedure.[13]

The Pensions and Lifetime Savings Association said:

> We agree with the Governments proposals for pooling and the need to ensure that fund are committed to delivering these pools. However, there is a risk that such broad powers, combined with a lack of an explicit fiduciary duty, could ultimately be used by a future government to direct what funds invest in, with limited regard to the impact to the payment of member benefits and the costs to employers and members. It would be reassuring for funds if there were greater checks and balances included in the regulations.[14]

In its response to the consultation, the Government said that:

> A significant majority of respondents claimed that granting the Secretary of State a power of intervention on investment functions would undermine the UK Government's stated commitment to transfer power to local government and would represent a serious attack on local democracy.

---

10 CLG, LGPS guidance on preparing and maintaining an investment strategy statement, 15 September 2016
11 20,000 people call on MPs to debate LGPS plans, UNISON website, January 2016
12 UNISON, LGPS funds guide, September 2016
13 LGA response to draft LGPS investment regulations
14 PLSA response to LGPS investment regulations, February 2016

However, it argued its approach was appropriate:

> This is not the case. One of the main aims of the proposal is to deregulate and transfer investment decisions and their consideration more fully to administering authorities within a new prudential framework. Administering authorities will continue to be responsible for setting their policy on asset allocation, risk and diversity. However, given the very large sums of public money at stake, we believe that it is entirely appropriate for the Secretary of State to be able to intervene where concerns have been raised, having taken account of all available evidence.
>
> In the case of the new pooling arrangements, the view is taken that it is appropriate for the Secretary of State to be able to intervene in circumstances where administering authorities are failing to comply with the criteria and guidance on the new pooling arrangements. This power would only be used where there is clear evidence that an authority is failing to comply with regulations, guidance or best practice.[15]

In answer to a PQ on 13 October, it said:

> We have received a large number of recent representations about the power of intervention in the investment regulations currently before the House. Under the new regulations, administering authorities are significantly more responsible and accountable for their investment decisions. They will no longer be constrained by central prescription on how their assets are invested, provided they act reasonably within the framework provided by the regulations and guidance.
>
> The power of intervention has been included in the regulations as a backstop in order to protect around £200 billion of funds in the local government pension scheme, in the rare circumstances where it might be necessary to do so. As set out in the Government response to consultation the regulations include a number of safeguards, including full consultation with the relevant authority, to ensure that the power is used appropriately and proportionately. We have made clear that the intervention power will be used sparingly and only where fully justified.[16]

Secondary Legislation Scrutiny Committee

In a report published on 20 October, the House of Lords Secondary Legislation Scrutiny Committee drew the attention of the House to these regulations on the ground that they gave rise to issues of public policy likely to be of interest. This was because significant numbers of consultation respondents considered the power of intervention to be incompatible with the independence of funds:

> Consultation by the Department for Communities and Local Government (DCLG) has shown high levels of opposition to the proposed power of intervention. In particular, 50 of 66 responses to the relevant consultation question did not agree that the proposed power met the objectives of the policy. While DCLG describes the power to intervene as a fall-back to protect public funds, likely to be used only rarely, significant numbers of consultation respondents consider that such a power is incompatible with the independence of the funds.[17]

In more detail, around three-quarters (76%) of respondents considered the proposed intervention power too broad and did not think it met the policy objective of allowing the Secretary of State to make a proportionate intervention:

> 7. In September 2015, DCG published a summary of responses to the 2015-16 consultation. This explains that there were 64 specific response to a consultation question on whether the proposed approach allowed the Secretary of State sufficient flexibility to ensure that he was able to introduce a proportionate intervention. 15 responses (24%) agreed that it did; 49 (76%) disagreed, commenting for example

---

15 CLG, response to consultation on the draft regulations, 27 September 2016
16 PQ 47874 12 October 2016
17 House of Lords Secondary Legislation Scrutiny Committee, LGPS (Management and Investment of Funds) Regulations 2016, HL Paper 53, 20 October 2016

> that the proposed intervention power was too broad, or that the power should only apply to the pooling arrangements. Noting the disagreement by a significant number of respondents, DCLG states in the summary that it remains "of the view that appropriate checks and balances are required in a framework that will significantly deregulate administering authorities' investment functions, particularly given the very large sums of public money involved". We obtained more information about these responses from DCLG, and we are publishing that information as Appendix 1.
>
> 8. The September 2016 summary also states that there were 66 responses to a question on whether the proposed power of intervention met the objectives of the policy, namely to allow the Secretary of State to make a proportionate intervention in the investment function of an administering authority if it had not had regard to best practice. 16 responses (24%) agreed that it would meet the policy objectives. 50 responses (76%) did not agree. Of these, 30 objected to the proposals in broad terms; 18 said that more clarification in guidance was necessary; and two suggested that the intervention power should only be considered on the recommendation of the scheme advisory board. DCLG refers back to its earlier response on the issue of the breadth of the power of intervention; and, noting that the Regulations in any case include provision for a report from the board to be taken into account by the Secretary of State before a direction is issued, it concludes that there would be no advantage in making further changes.[18]

As regards pooling, the Government told the Committee that "in practice, good progress is being made towards pooling and the Secretary of State currently has no intention of intervening".[19]

2.5 Boycotts, divestments and sanctions

As stated above, LGA guidance for administering authorities explained that "the precise choice of investment may be influenced by wider social ethical or environmental considerations, so long as that does not risk material financial detriment to the fund."[20]

This broad approach is echoed in the CLG guidance published on 15 September, although it also states that investment policies should not run contrary to UK foreign policy:

> The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors, and over the long term, dependent on the time horizon over which their liabilities arise. However, the Government has made clear that using pension policies to pursue boycotts, divestment and sanctions against foreign nations and UK defence industries are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government. Although schemes should make the pursuit of a financial return their predominant concern, they may also take purely non-financial considerations into account provided that doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision.
>
> Investments that deliver social impact as well as a financial return are often described as "social investments". In some cases, the social impact is simply in addition to the financial return; for these investments the positive social impact will always be compatible with the prudent approach. In other cases, some part of the financial return may be forgone in order to generate the social impact. These investments will also be compatible with the prudent approach providing administering authorities

18 House of Lords Secondary Legislation Scrutiny Committee, LGPS (Management and Investment of Funds) Regulations 2016, HL Paper 53, 20 October 2016

19 Ibid, Appendix 1

20 Investment in local infrastructure projects vital, says Committee, 30 November 2015 LGPS Advisory Board, Advice on Fiduciary Duty with regard to the investment of Local Government Pension Scheme (LGPS) funds, April 2014.

> have good reason to think scheme members share the concern for social impact, and there is no risk of significant financial detriment to the fund.[21]

War on Want expressed concern. It expected the guidance to clarify how investment plans should comply with the statement:

> The government clearly intends to deter local councils from taking divestment action. However, where this intimidation fails, central government will still have the final say through the 'power of intervention' (see question 2).[22]

The Government's response to the consultation said:

> The majority of respondents also expressed concern about the way in which the policy on compliance with UK foreign policy is to be taken forward in the guidance to be published under draft Regulation 7(1). However, the Government remains committed to the policy set out in November's consultation paper that administering authorities should not pursue investment policies against foreign nations and UK defence industries, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government.[23]

Further reading

Other Library Notes of relevance are:

- SN-06594 Infrastructure policy (May 2016); and
- CBP-07309 LGPS investments (April 2016).

[21] CLG, LGPS guidance on preparing and maintaining an investment strategy statement, 15 September 2016
[22] War on Want – protect local democracy Q and A
[23] CLG, LGPS Revoking and replacing the LGPS (Management and Investment of Funds) Regulations 2009. Government response to consultation, September 2016