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POLICY BRIEFING NOTE:

Local investment in the LGPS


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The Government's current Pensions Investment Review has a clear aim of increasing the level of pension scheme investment into the UK. While a lot of the talk has been about financing large-scale infrastructure projects, for the LGPS, the government has focused specifically on encouraging "local" investment. This briefing note looks at what is proposed and offers thoughts on the consultation questions.

The Pensions Investment Review Call for evidence asked about the potential for the LGPS to increase net investment in the UK and the possible impact on UK growth.

Our response set out our belief that the LGPS' greatest potential for additive UK economic growth is leveraging its regional expertise to support smaller, local investment – including using the credibility of the LGPS money to 'crowd-in' further private investment and the ability to catalyse further new local projects. We're, therefore, supportive of the policy direction on local investment. However, we would encourage realistic timelines for the LGPS to increase local investments, to allow for a flow of newly originated local project opportunities to be created. This will avoid forcing capital into a small set of opportunities, 'bidding up' prices and pushing down returns.

What is local investment?

Impact investing can be defined as where an investor deliberately sets out to make the world a better place in a material and measurable way. Local investing follows this same principle: impact is targeted on a particular geographical region, with the goals of improving the physical place, the lives of people within the region, and its future economic prospects. All this is done alongside generating market-level returns.

Based on this articulation of the purpose and aims of local investing, the key aspects that require further clarity and a common understanding if it's to be a success are:

- Narrowing the definition of "local".
- Guidance for implementing through the pools.

Key beliefs driving current LGPS positioning

LGPS funds have been divided on local investment, with views having fallen into three main camps of *for, against*, and *accepting* of investment in the local area for purely financial reasons.

'For' camp

There are three main reasons why funds have embraced local investment:

1. A core belief that it's an important role of the fund to support its local area.
2. A means of strengthening the local economy and/or improving the strength of the employers, like the council, and their ability to pay contribution rates.
3. A way to leverage local connections to find investment opportunities that would otherwise not be funded, perhaps sourcing attractive opportunities.

'Against' camp

Those funds that have been resistant to local investing as an 'asset class' have typically taken this stance for one, or both, of the following reasons:

1. The issue of conflicts of interest, actual or perceived, where the pension fund is being used to support local areas over the optimal level of risk-adjusted returns it should seek. This could be exacerbated by the decisions of local councillors who, in their wider roles, would like to see those investments be made.
2. The practical challenges of local investing. In particular, local investing can often command a disproportionate amount of resource to find and assess appropriate investments (with implementation and ongoing monitoring also time intensive). Meanwhile, it can be difficult for those directly involved in the fund to distinguish between a good opportunity for their local area versus the opportunity on pure investment grounds – this often contributes to conflicts of interest.

'Financial concerns' camp

And finally, there are those that are concerned about the financial viability of local investing. The financial concerns shared by funds are typically driven by limiting return potential. In particular, is it good practice for an investor with a fiduciary duty to its members and employers to limit its investment opportunity set to its local area?

Funds may also be concerned about the potential impact from the concentration of investment in the local area. This creates the risk that if a local economy struggles, then there is greater potential for local investments to underperform. This will happen at a time when the same employers may also be struggling and thus less able to pay higher contributions.

Current approaches to local investing

Many funds have investments within their local area, but not because of a conscious action to invest locally. Rather, these can occur as a result of investment in a UK-wide or even global fund, where the fund manager has identified a strong investment opportunity in that particular fund's local area. In practice, this is a good way for a fund to invest locally, but the fund has no control, so the manager could just as easily increase the local investment further or reduce it to zero if deemed appropriate.

However, there are a number of LGPS funds that explicitly invest in their local area, often with a dual aim of earning strong returns and having a positive impact on the area. The following three examples illustrate how the LGPS is doing this in practice today:

- **Greater Manchester Pension Fund (GMPF)**. Benefiting from being the largest LGPS fund, GMPF has been able to dedicate the resources to building an in-house team to find investments locally. In this case, “local” means Northwestern England and West Yorkshire, and investments are based on an assessment of financial risk and return, it being a pre-requisite that the portfolio as a whole meets the overall fund requirement return, and individual investments have market levels of risk-adjusted return. Social, economic and environmental impacts are targeted in line with the Combined Authority objectives and these, alongside the financial results, are measured independently by The Good Economy. GMPF has committed £1.5bn to local and impact investment through the Greater Manchester Property Venture Fund and its Impact Fund. Investments are made both directly and through funds.
- **Merseyside Pension Fund (MPF)**. The MPF Catalyst Fund provides debt and equity investments for projects that deliver economic growth to the Liverpool City Region, upgrade housing, regenerate deprived communities and maximise the use of new spaces in the city. An example of an investment within this fund is a loan to develop the Mersey Heat Network, a project helping to regenerate the Liverpool waterfront and provide cleaner energy to local homes and businesses. The Catalyst Fund invests over £60mn locally.
- **Cornwall Pension Fund**. Given its smaller asset size, Cornwall has more limited in-house resource, so it sensibly uses external fund managers to source and assess investment opportunities for the Social Impact Portfolio. This looks for impact investment opportunities in Cornwall, in addition to wider regional, national and potentially international opportunities. The investments identified for the portfolio must be defined by alignment to the United Nations Sustainable Development Goals. Through this, it has employed external managers to help invest £65mn in affordable housing within Cornwall, and £50mn in renewable energy within the UK, with £25mn of that in Cornwall.

As can be seen from these examples, there’s a wide range of approaches to local investment, with each suited to the funds’ beliefs, requirements and resources.

What is the Government's proposed approach?

Under the government's new proposals for local investment, "local" is defined as investments local to any of a pool's partner Administering Authorities (AA) or investments in the funds' own regions.

Breakdown of responsibilities

Stakeholder	Responsibility
Pool	Responsible for all aspects of implementation, including due diligence, of any local investments that are made. Advise on the funds' approaches to local investment, including target allocation range.
Funds	Set out their approach to local investment, including setting a range of their asset allocation that they would like invested locally (eg 0–5%) in their Investment Strategy Statement.
	Work collaboratively with local bodies, such as combined authorities and mayors, to ensure local growth plans and economic priorities are factored into sourcing local investment needs and opportunities.
	Share identified needs and opportunities with the pool.
	Include in the annual report details including the level of, and impact achieved from, investment in local opportunities.

Potential benefits of the proposals

A key advantage of LGPS funds is their connection to local economic activity, needs and opportunities. In theory, requiring funds to identify the most attractive opportunities in their regions means opportunities are being sought out by those with the most knowledge of the landscape. Providing capital to develop local infrastructure and utilising local connections to develop investment opportunities should result in capital flowing into areas of the country that would not otherwise be invested in due to lack of awareness, scalability, etc.

Potential drawbacks of the proposals

The main drawbacks of the Government's proposals and split of responsibilities are linked primarily to the lack of clear guidance. The pool's responsibilities are unclear in relation to gathering the information regarding local opportunities as well as assessing and ultimately allocating capital within the pool's local investment allocation. Barriers that will halt the progress of the Government's proposals stem from issues of governance, resource, need and the associated conflicts of interest. Questions such as those listed below are just a few of the hurdles that must be overcome if the Government's proposals are to be implemented effectively:

- Where should regional boundaries be drawn?
- How are investments evaluated against the alternatives?
- What are the necessary skillsets to evaluate the deals within funds?

What can we learn from those LGPS funds that have front-run this?

Those who have taken steps to make local investments have overcome these challenges in different ways, but we would suggest that the core components for success have been:

- **Flexibility in the definitions of what comprise local**. While there are examples of regional investments set out above, others have allowed a UK-wide investment universe in the expectation that this will collect investment in the local region.
- **Partnering with specialist asset managers.** Skillsets to undertake the necessary due diligence on potential investments have been obtained through working with specialist asset managers. The outsourcing has allowed funds to achieve their investment goals in a resource-efficient manner.
- **Appropriate legal structures around investments.** Governance challenges can often be overcome by ensuring that there are appropriate legal wrappers around investments. This creates an infrastructure that segregates investments being made on behalf of funds.

What is essential for the Government's plans to be successful?

The implementation of the Government's plans for local investment will be complex, with many interlinked parts. However, at the core of the plans is the desire to boost investment in local economies in the UK and for that to be a success. We believe that there are a few non-negotiables:

1. A clear articulation of what defines "local", where the definition balances clarity with flexibility.
2. Guidance that the pools must operate within when allocating to local investment opportunities to ensure proportionate diversification across member funds in the pool.
3. Define what the required skillsets, investment and legal, are to appropriately invest locally and, if not demonstrated by the pool and the AA, require specialist asset managers to be appointed.
4. Ensure asset allocation guidance provided to the pool for local investment appropriately balances return and risk.

Illustrative guidelines

By way of example, the following guidelines for the pool would start to capture some of the key success features outlined above:

- Minimum of 50% of the pool's local investment's must be split by region, based on a weighted average of the total assets of the member funds in that pool.
- Remaining local investment allocation in the pool can be invested across the UK, in regions not represented by the member funds.
- Initial pool local investment allocation will be based on the in-specie transfer of local investments from the member funds where possible.
- Pools permitted a restructuring period of 3–5 years to achieve the minimum 50% local regions and balance across the rest of the UK, with a comply or explain approach adopted to avoid the forced sale of assets.

The above guidelines will help balance support for existing investments, costs of selling and buying, diversification, local-regional support and local-UK support.

Pooling has demonstrated a range of different approaches with experience now allowing pooling implementation to be refined. We believe that local investment should be approached in a similar manner. We believe that

Government should permit flexibility in the implementation of local investment to ensure that the best risk, return and impact is delivered for all stakeholders. Government should commit to gather evidence based on collective experience to assess the extent to which its broader policy objective of driving local investment and assessing impact has been achieved.

Further considerations for LGPS funds

We set out below the issues we think funds should consider, as well as our own views, on the questions included in the government's Fit for the Future consultation.

Question 13: What are your views on the appropriate definition of 'local investment' for reporting purposes?

The question specifically asks about local investment for "reporting purposes", rather than for investment purposes, which we believe is an important distinction. This implies the potential for differences to arise through the investment process, which, while it could be appropriate, creates an unhelpful disconnect. For an AA, the most obvious definition of local is the region served by the AA. Drawing on question 17 of the consultation, if reporting is required in the form proposed, this would be most appropriate.

Recognising that some investments could have impact over multiple regions and that a commingled approach to local investment may be applied, we believe it would be inappropriate to adopt a single definition. We suggest that reporting address local investment at three levels: fund area, pool area and country. This would facilitate more informed reporting, allowing AAs and pools to demonstrate impact in different ways.

Question 14: Do you agree that administering authorities should work with their Combined Authority, Mayoral Combined Authority, Combined County Authority, Corporate Joint Committee or with local authorities in areas where these do not exist, to identify suitable local investment opportunities, and to have regard to local growth plans and local growth priorities in setting their investment strategy? How would you envisage your pool would seek to achieve this?

There are clearly opportunities for administering authorities to work with other parties to identify potential local investment opportunities, but clarity is needed on the expected route to implementation.

As it stands, the Government is expecting each fund to identify potential opportunities that will be proposed to the pool for consideration, including due diligence and underwriting. This creates a need for internal resource with appropriate skillsets at both the Fund level and the pool level, and the division of responsibility between pool and funds to be clarified. In particular:

- Funds need to be able to identify what may or may not be appropriate forms of local investment and will, in turn, need appropriate investment guidelines covering what is acceptable to be clearly established.
- The pool acts as an aggregator of capital across all funds and thus is required to evaluate the relative merits of different opportunities from the member funds.

For example, will funds be required to pass through all opportunities to the pool, or undertake some form of assessment themselves on what should be passed through? The former will place a large workload on the pools, but they should be better placed to provide this assessment than the funds.

The complexity of skills required is further increased when considering local investment by asset type eg equity financing, debt financing and property/infrastructure. For example, getting diversification within an asset class may be more difficult in infrastructure compared with private equity. Similarly, achieving diversification by industry/sector/economic driver will also be more straightforward in some asset classes than others.

In many cases, the skillsets to identify, assess and monitor/manage on an ongoing basis do not currently exist at the funds and/or pools, but these are essential if the right opportunities are to be identified and invested in. Therefore, we would expect most pools seek to achieve the local investing agenda objective by:

- leveraging the skills and expertise of those member funds that already allocate to local investments
- utilising the skills and expertise of external managers, particularly for ongoing management of the underlying assets.

The governance and guidelines around how the pools allocate to local investments put forward should be structured to instil confidence in the funds that the pool is willing to consider the opportunities and that there are conflict-management processes in place as well as deal attribution. As outlined in the “Illustrative guidelines” section above, we would envisage some formal guidelines to be in place to ensure each member fund in the pool has their local region fairly represented.

And so, while we believe there are strong benefits to having AAs work with local bodies to identify opportunities in their region, we note that this will not be achievable from day one and will incur costs (time and money) to get the relative skillsets and guidelines in place. As indicated above, we would expect:

- Pools to leverage the good work done by their member funds, at least in the initial phase.
- Clear requirements for pools to represent every member fund and their associated AAs fairly.
- Pools to ensure a diversified portfolio of local investments, which we believe is most easily done by requiring a mix of local-regional opportunities and local-UK opportunities.

Question 15: Do you agree that administering authorities should set out their objectives on local investment, including a target range in their investment strategy statement?

We note that the consultation does not ask for opinions on whether funds should invest locally. We do ask whether a fund setting out an approach that they do not believe in local investment, and setting a target allocation of 0%, would be accepted by government.

The consultation suggests that funds should set out their objectives on local investment, including a target allocation range. We support this. Strategic asset allocation should remain a local investment decision, given that funding objectives and investment policy decisions will otherwise remain with the AAs.

The proposals, however, do not clearly address how local investment overlaps with the proposed framing of strategic asset allocation. Therefore, if a target range approach is taken, then it would mean AAs would need to consider local investment as an asset class in its own right. The AAs would need to delegate authority to the pool on the underlying investments, which may include multiple asset classes (eg property, equity, debt, infrastructure). AAs must reflect this in their investment strategy statement to acknowledge that eg a 10% allocation to private equity is excluding any private equity exposure invested in locally – so, in practice, private equity exposure could be upwards of 10% at any one time, depending on the local investment allocation.

The alternative approach that we’ve seen some funds take is to consider the high-level asset allocation to each asset class and target an allocation local investment within that. For example, target 10% to private equity, 1% of which should be local private equity investment. While this approach is cleaner from a strategy perspective for the funds, the management of this at will be complex, costly and difficult to achieve appropriate diversification across sector and region.

Both approaches have their merits and drawbacks. As indicated in the next section, we are in favour of the Government delegating to the pools on their choice of approach. In doing so, this will allow each pool to work with the member funds and their AAs to make the integration of existing assets into the pool as effective as possible.

Question 16: Do you agree that pools should be required to develop the capability to carry out due diligence on local investment opportunities and to manage such investments?

We believe it appropriate that there is a clear mechanism through which due diligence on local investment opportunities can be undertaken, and investments made and subsequently managed on an ongoing basis. However, we also recognise that this requires access to considerable expertise and different skillsets, depending on the asset class.

Before progressing this requirement, Government should be clear on how it expects local investment to be implemented. For example, if a pool creates a multi-asset local investment fund, then it will require the skillsets to evaluate investments across different asset types, suggesting there would be a need to develop a broad range of resource. Further, different skillsets will be required if the investments are made directly or if they are made through a pooled vehicle.

Rather than mandating a single approach, we believe that Government should set out the broader framework through which it expects local investments to be considered. It should also allow pools to consider how best to access the skillsets and capabilities that would let them meet their mandate and the requirements of funds.

Question 17: Do you agree that administering authorities should report on their local investments and their impact in their annual reports? What should be included in this reporting?

The consultation document suggests that reporting serves to make the funds accountable, yet the proposals are for local investment to be made via the pool, so the proposal seems inconsistent. Further, while we believe that reporting may be helpful, we believe the government should establish some clear principles for reporting on local investments to ensure clear, fair and not misleading descriptions of each funds' assets.

- Reporting should serve a clear purpose for administering authorities and be undertaken to meet the needs of stakeholders. While the Scheme Annual Report may be an appropriate forum for reporting, it's unlikely to be appropriate as a communication vehicle for members.
- Reporting should not duplicate reporting undertaken elsewhere. For example, if reporting on local investments is being provided by pools (who it is proposed be responsible for the implementation of local investments), then it would seem more appropriate for such reporting to be provided at a pool level. Funds could then reference pool reporting as necessary.
- Reporting should, as far as practicable, be consistent with other reporting frameworks. For example, the FRC is currently consulting on revisions to the Stewardship Code, and it would be appropriate that any form of reporting on local investments be undertaken in a similar manner to ensure that reporting efforts are not duplicated.
- Reporting should be proportionate and not create unnecessary cost and/or governance burdens on funds. Impact reporting is generally less well developed than other forms of stewardship reporting, and the mechanisms for calculating impact are likely to be more subjective than performance reporting.

In addition, we believe it's appropriate that Government clearly set out the investments that fall in and out of scope of any reporting requirements. For example, a number of funds have already made impact investments. Clarity is therefore needed as to whether these would require to be reported on in addition to any new investments. This is an important consideration because it could cause a pause in investments while funds wait for pools to set up their services.

If you would like to discuss any of the topics covered in the briefing note, [please get in touch.]

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