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Briefing note

Government consultation – LGPS (England & Wales): next steps on investments

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The long-awaited government consultation on Local Government Pension Scheme (LGPS) investments has been out long enough for the government's vision for the future to sink in. Here, we follow up our 60-second summary with our views on the key themes of the consultation, as well as areas where we feel more clarity is needed.

In summary

- We agree that pooling should be completed as quickly and extensively as possible, where it's achieving clear benefits for funds. But the government should give further consideration to the ambitious timescales, as well as reasons for funds to maintain assets outside of the pool.
- The challenge of passive assets also needs a sensible approach from government.
- To increase the scale of pooling, we'd like to see clear evidence and a reason for targeting £50–75 billion of AUM, to justify the further costs, especially where it will only be achieved by merger.
- Further thought is also needed on the optimal scale for different asset classes and potential diseconomies of scale, including the governance impact of pushing together several member funds.
- The use of in-house management has benefits, but there are also arguments for using third-party investment managers, and a 'one size fits all' approach should be avoided.
- Under improved governance, we agree that high-level investment strategy decisions should remain with pensions committees, but we predict issues with the pools taking on all other implementation considerations. We see the decisions as being intertwined, so given the fiduciary responsibility of individual authorities to ensure pensions are paid, individual funds must keep a say in how their strategies are implemented.
- We're also concerned about the pools providing investment strategy advice to their member funds. Some are not currently equipped to provide this, and it could concentrate risk.
- On adopting best practice, we don't feel there's clear evidence of one single approach being better than the rest. There are strong benefits to different approaches that we feel need to be preserved.
- On financing support for Levelling Up, it's helpful to receive clarity on how the government sees the role of the LGPS. Many funds will already meet the requirements, but stretched pensions teams will also have to accommodate additional reporting. Meanwhile, it's unclear how genuinely attractive investment opportunities will be originated by pools and funds.
- We believe it's not appropriate for government to prescribe allocations to specific asset classes, eg a 10% allocation to private equity, given the fiduciary responsibilities of individual authorities in respect of managing their fund's assets and their responsibilities in ensuring pension payments are made.

Theme 1: accelerating pooling

An unmistakable message from the consultation was government's support for pooling to continue. In fact, the pressure to pool has been ramped up by a desire for the pace to increase. Government also offered a clear steer on the form of pooling it believes is most beneficial: pools having 'ownership' of assets, selecting managers and negotiating fees, rather than simply an oversight role. Ownership in this context means 'control or responsibility over', as the assets remain under the ownership of the pension funds.

To date, pooling has achieved a range of benefits for LGPS funds. As well as fee savings, pooling has generally helped funds strengthen governance, responsible investment and improved their access to private markets asset classes. While it hasn't all been plain sailing, and there are some drawbacks to pooling, these were the benefits government intended, so going further and faster makes sense.

A focus on liquid assets

One key method to achieve this acceleration is a potential requirement for all 'liquid' assets to be pooled by 31 March 2025, thereby focusing on the assets that are easiest and least costly to transition. Sensibly, there is no firm deadline for illiquid assets, but the government would like to see as much progress as possible by that date. Increased transparency in the form of requirements for annual reporting by funds on their pooling progress, including explanations for assets not yet pooled, or where there is no intention for them to be pooled, will also increase pressure.

The target for these measures is likely to be those funds that the government sees as unnecessarily keeping assets outside of their pools. In reality, assets may be held outside for sensible reasons. For example, it could be uneconomic for the pool to offer a solution that meets funds' specific requirements in critical areas such as diversification of risk or the transition to net zero. While we acknowledge the needs for funds to compromise in the interests of pooling, such reasons are likely to remain valid. We believe some flexibility is needed here, which could improve pooling outcomes. Further guidance from government on the degree of flexibility funds will have, and on the obligations of pools to offer solutions whatever the cost, would be helpful.

Practical considerations

The proposed timescale of pooling all liquid assets by 31 March 2025 is also potentially very challenging. While a quicker pace of pooling may well lead to the benefits being realised sooner, it is equally important that it is done effectively. It takes time to design solutions in consultation with investing authorities, carry out any necessary procurement (fund managers and other service providers) and launch funds. Some pools may already have other specific and necessary projects in their 2024 business plans. It may take a couple of years after the regulations are implemented for the necessary solutions to be implemented through the pools and assets transitioned into them.

What about passive assets?

Careful thought is also required on passive assets. In response to the pools being set up, passive managers significantly cut their fee rates, and these assets are now managed under LGPS umbrella commercial agreements, in some cases with pools having oversight of the assets, meaning they are pooled, basically. This severely limits any possibility to reduce fees further by moving these assets within the pool once the pools' fees are added on. The low passive-management fee rates also make it difficult for pools to develop in-house passive capabilities as cost-effectively. It's arguable that within passive management, the benefits of pooling have already been achieved via a route that is not strictly under the definition of a pool-controlled asset.

With regard to the increased reporting regarding pooling progress, we believe significant thought needs to be given to the increased workload placed on already stretched pension teams. Simplified templates that are easy to complete are a must to alleviate the burden on pensions officers.

Theme 2: capturing the benefits from increased scale

The government is also pushing for increased scale in asset pooling. The previous requirement for pools to have assets under management (AUM) of £25 billion has now increased to £50–75 billion. While there are clear economies of scale in asset management, further consolidation to achieve optimal scale will be costly and disruptive, so we believe it is vital to have clear evidence that £50 billion is the correct number. The optimal size of AUM can also differ by asset class.

This is especially important for the pools that are not currently capable of achieving £50bn of AUM, due to the combined value of their member funds not meeting this level. Here, the government has indicated that they would require mergers of the sub-scale pools to achieve this. This requires significant thought and care, as the work and costs involved will be significant. Transparent cost-benefit analysis is required to ensure any increased benefits from larger scale are expected to more than meet the outlay of a merger.

Diseconomies of scale also exist. Careful consideration is required of the impact on governance of increasing the number of member funds in a pool. It goes without saying that the greater the number of funds a pool has to please, the harder it will be to please all of them. If this then leads to a proliferation of solutions being designed, it negates the benefits of increased scale. Similarly, it may well lead to slower decision-making and reduced responsiveness to market opportunities. It can also lead to reduced engagement with member funds, who remain responsible for paying LGPS pensions and have fiduciary responsibilities. It’s interesting to note that some smaller pools have achieved excellent results from pooling, so absolute size is not a guarantee of better outcomes.

Funds with in-house capabilities

A plan to extend the benefits of scale is for pools to make greater use of in-house capabilities. Government sees this as a way of removing the layer of fees charged by external managers. Again, we believe this requires very careful thought. It appears government’s preferred approach to this is for funds that have in-house capabilities to share these within their pools. To some extent, this is happening already. Some pools brought across experienced in-house teams from members’ funds at the outset. This was a great way of leveraging their expertise, and has largely been successful. This is likely significantly easier than setting up in-house capabilities from scratch. However it’s done, it will still be challenging to build teams, and the infrastructure around them, that can compete in mainstream asset classes and more efficient markets. This is shown by the significant proportion of active managers that consistently underperform the market. While some of this underperformance is down to fees, which in-house management would partially address, it’s largely due to the challenge, even for the most experienced and well-resourced managers, of consistently finding investments that outperform. Underperformance could easily outweigh the benefits of lower fees.

Holding managers to account

In-house management may also make it more difficult for member funds to adequately hold their investment managers to account. When pools appoint external fund managers, they can easily be replaced if the pools believe they no longer have a place in the investment fund. This was, in fact, a key reason for the pools to be set up – to take the difficult decisions of hiring and firing managers away from pensions committees. Moving to internal management would mean removing employees of the pool, something far harder to do. This may lead to funds being locked into longer periods of underperformance with limited recourse to remedy it.

In-house specialisation

The government has proposed that pools specialise in the areas of in-house management where they are particularly strong, and that funds invest across pools to gain exposure to the required specialism. We agree that this makes sense, as it will allow pools to dedicate greater focus and resources to their own area of specialism, and allow for greater pooling of assets in each area. However, this is likely to take longer to come to fruition and will concentrate a larger share of LGPS AUM into a single solution. In addition, the larger the number of funds wanting to invest in a

solution, the more difficult it will be to please everyone. Funds investing in other pools' solutions may also need to accept that they will have less influence over the strategy than the member funds of that pool.

Theme 3: strengthening governance

Firstly, we are extremely supportive of the confirmation that the incredibly important decisions regarding setting investment objectives, risk appetite and high-level investment strategy remain with the funds. These are the most important investment considerations for any long-term investment fund, so it's critical that those decisions remain with pensions committees as long as they are responsible, and therefore have a fiduciary duty, to pay those pensions.

The issue of delegation

However, the government is proposing that all other investment decisions be delegated to the pools, including various implementation decisions previously taken by member funds.

We believe that the separation between the high-level allocation decisions and implementation is not as clear-cut as the consultation suggests. Many implementation decisions are critically dependent on the objectives, risk appetite, investment beliefs and policies on key issues such as net zero, which are set by pension committees. It's very hard for third parties, ie pools, to take such decisions with confidence and ensure that the solutions they develop are fully aligned with funds' requirements. Currently, funds make a decision to invest in an asset class and then work with the pool and other member funds to agree on what the pool's solution in that asset class should look like. While compromise is required, member funds have the ability to influence the design of that fund to fit in with their requirements. If all investment decision-making is delegated to the pools, funds may lose the ability to influence the design of pool solutions and end up invested in funds that do not meet their high-level strategic needs. We believe that a collaborative approach between pools and member funds, involving challenge and compromise, has delivered better solutions and investment outcomes for clients.

Advice concerns

We're also concerned by the proposal that pools should be the source of advice to member funds on their investment strategy. Combining strategy advice and implementation or, in other words, replicating the traditional fiduciary manager model, is known to create conflicts of interest. For example, in the case of pooling, pools may be incentivised to develop easier-to-run, simplified solutions that do not fully reflect each member funds' specific needs. Similarly, assets may be directed towards solutions where the pool is trying to build scale, rather than the optimal strategies for each member fund. Member funds would not fully benefit from the protections recommended by the CMA in its 2019 review. The proposal would also increase concentration risk by increasing the influence of pools on ultimate investment outcomes. In the interests of full disclosure, we should, of course, highlight our commercial interest in this area.

We support requirement to develop formal training policies and increase the level of training provided to pension committees. Committee members have onerous fiduciary obligations and are responsible for taking significant decisions on a wide range of increasingly complex investment matters. Many funds already have policies and extensive training programmes in place, but increased focus on this area across the LGPS is likely to beneficial.

Finally, stronger governance is not just about the delegation of decision-making to pools. The Good Governance review identified many other opportunities to improve governance and we strongly encourage the government to take forward its recommendations.

Theme 4: adopting best practice

Through the pooling process so far, a number of operating models have been developed. The government, in its consultation, has set out a clear preference for a single model of pooling: an asset manager with significant assets under management that it has full responsibility for, that itself is fully owned by its member funds. The government has stated that the greatest benefits of pooling can be achieved in this way.

However, we don't believe there is one single, best approach. There's clear evidence that other models are delivering the key benefits of pooling of lower fees, improved net-of-fees returns, better governance and access to a wider range of assets. Some alternatives allow for greater accountability by making it easier to address under-performance, eg by replacing the investment manager.

There are also important lessons to learn from progress made so far, which we believe have been missed in the development of this consultation, such as the benefits of involving member funds in fund-design processes from an early stage.

We believe that moving towards a single operating model exposes the sector to unnecessary concentration risk and may stifle innovation. We also believe that more experience with the different models is needed before sufficient evidence can be gathered to adopt just one approach.

Theme 5: financing support for Levelling Up and faster economic growth

Since the use of LGPS investments to finance the government's Levelling Up agenda was first mentioned in Michael Gove's white paper back in early 2022, uncertainty of what this would actually entail has hung over funds. An additional requirement to provide venture/growth capital subsequently appeared in the Edinburgh Reforms and the Chancellor's recent Mansion House Speech and most recent Budget. This has made it challenging for funds to take certain actions for fear that they would go against future Levelling Up requirements.

Some welcome clarity

The clarity offered by the consultation is greatly welcomed. It's incredibly helpful to have confirmation that the "up to" 5% target includes current investments already made by funds, and that it will include all asset classes and all areas of the UK. The 12 missions that investments must address in order to count as Levelling Up investments also bring valuable detail, as does the confirmation that investments must still meet pension committees' fiduciary duties.

The fact that LGPS funds will already hold investments that meet these criteria means that many funds may already be meeting this potential requirement. LGPS funds have always been happy to invest in the UK if the opportunities offered attractive risk-and-return characteristics. For these funds, the main impact will simply be increased reporting requirements. While we agree improved transparency is generally to be welcomed, we are aware this will further increase the workload for pension teams in an area which is not directly connected with the primary purpose of their funds.

The role of LGPS funds in Levelling Up

We are very supportive of any actions taken to simplify the origination, management and reporting of Levelling Up investment and would agree with the suggestion that the pools have a key role to play in this area. The pools are better placed to build the necessary investment expertise, and they also offer a layer of separation between the funds and the investments, helping to reduce any issues of conflicts of interest that can occur when investments are local to funds.

The reason most often given against investing in UK Levelling Up assets is that it will force capital into a small set of opportunities, 'bidding up' prices and pushing down returns. We agree that focusing on newly originated opportunities, rather than relying on assets purchased in the secondary market, may help to answer this. The funds are also uniquely placed, as they can leverage their relationships with their administering authorities to help find these opportunities. However, new origination is challenging and is the focus of most investment managers already active in the relevant asset classes. It's not clear that the involvement of LGPS pools/funds, in isolation, is going to unlock a large volume of attractive investment opportunities that would not otherwise have come to market.

We believe more help is needed here to make this work for the LGPS. The government can and should take action to increase the flow of attractive investment opportunities coming to funds. Actions such as streamlining applicable planning processes, risk sharing on more complex projects, supporting newer technologies, stronger policy

funding support for education, skills development and research could all help over the longer term.

What about private equity?

The government also proposes a requirement to invest 10% in private equity in order to earn higher returns and help support economic growth (with the consultation suggesting a focus on venture capital and growth equity). While the wording throughout the private equity section discussed opportunities to support the UK, the requirement is simply to invest 10% of assets in private equity, with no regional constraints.

We believe private equity has a role to play in long-term investment portfolios, including those of many LGPS funds. Carefully chosen investments can deliver returns well in excess of those available from public markets, but venture and growth capital are among the highest-risk investments a fund can make. We also acknowledge that readily available private equity finance can significantly boost economic growth. But any material allocation to these areas needs careful consideration.

Further clarification from government would be very helpful, in this area in particular.

The consultation proposes that funds maintain local control of their strategic asset allocations and set them to best meet their own local circumstances. We see this requirement to invest 10% in a certain asset class as a direct contradiction to this principle, and one that may conflict with the risk appetite of many funds.

When combined with the government's Levelling Up agenda, private equity investments do make sense. Investing here is providing capital at the grassroots of the economy, helping budding new businesses to get off the ground and grow, creating jobs and economic growth. However, from an investment perspective, limiting investments to just the UK would significantly reduce the opportunities available to investors and lead to concentration risk.

In conclusion

This consultation sets out a number of positive steps for LGPS investments, but some areas require further thought and detail from government. We'll be responding to the consultation prior to the 2 October deadline, setting out our opinions to government, and would encourage all interested parties to make sure they have their say on these extremely important issues for the LGPS.

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