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POLICY BRIEFING NOTE:

Mandation to our nation?

With the expectation that Thursday evening's Mansion House speech will make a policy announcement impacting the LGPS, and the Pension Investment Review due to report back in the coming weeks, speculation is heightened about what will be required from the LGPS.

There is some comfort in the news that we shouldn't expect "surprises", meaning another consultation seems the most likely next step. However, all roads eventually lead to the UK government expecting LGPS funds in England & Wales to increase investment in the UK. With the uncertainty that this would cause, we've set out in this article some thoughts on how funds would go about increasing UK allocation at pace.

How did we get here?

The idea of the LGPS investing in the UK to support the nation or a local area, whether that's socially or economically, has been around for a long time. However, it moved from a philosophical debate to genuine policy considerations in 2022, when Michael Gove mentioned the potential for the LGPS to contribute to "Levelling Up" the UK in his white paper.

In 2023, a government consultation on LGPS investments was launched, considering a wide range of issues, including a 5% target to invest in "Levelling Up projects". Then, this year, after winning the General Election, Labour swiftly launched a Pension Review. This quickly led to a Call for Evidence on pension investments, covering both the LGPS and Defined Contribution pension schemes, again including investing in the UK. "Levelling Up" was dropped, being replaced by terms like "productive finance", "UK equity" or simply "UK investment". Whatever the title given to it, Labour have made it clear that their aim is for the investments to drive economic growth.

Why is the government considering this?

Labour stated clearly throughout their election campaign, and again since coming into government, that their top priority is economic growth. A lack of public and business investment is widely blamed for the UK's poor productivity record and low levels of economic growth, particularly when compared to other advanced economies. Therefore, it's widely recognised that more investment into the UK economy is required.

However, the government find themselves in a difficult financial position, with the National Debt at record levels. Combined with their campaign promises not to raise taxes on "working people", they need to find money for this investment from somewhere. As the previous government did, Labour's first port of call is pension schemes as that source of cash.

What does this mean?

There are many unknowns about the possible approaches the government might take towards the LGPS, which we discuss later in this article. However, from a high-level perspective, the government clearly wants to see the LGPS investing a larger share of its assets in a way that boosts the UK economy. This may be funding for infrastructure projects, such as renewable energy generation or new transport infrastructure. Similarly, it may also be in Venture and Growth Capital, a high-risk investment involving providing money to very small companies to help get them off the ground and grow.

It may also be in housing, as Labour have identified that as a key national issue they wish to fix, with their ambition to provide 1.5 million new homes over the next parliament.

The practicalities

If the government is considering a target UK allocation, much more information would be needed to allow funds to confidently implement it. This includes:

- The proportion of assets the government wish to see each fund invest in the UK.
- Whether this target includes investments already held or is addition to this.
- When this target needs to be met by.
- The types of investment that will fall within their definition and contribute towards the target.
- Whether this takes precedence over pooling requirements, if the pools don't have a solution available.

Until these details are known, it is difficult for funds to begin to take action.

What else is the government doing about this?

The key issue for the government is to address the reason why UK investment wasn't as high as they wanted in the first place. While the LGPS does invest a relatively large proportion of its assets in the UK (most funds typically invest 25–35% in the UK), responses to this year's Call for Evidence listed the wide range of reasons for why the LGPS invests most of its assets overseas. These included good investment practice, such as diversification, as well as specific issues with the UK, such as policy risk, the investment opportunity set and the costs of investing.

If the government does not address these issues, it would result in assets being forced into investments the LGPS would otherwise not make. This is typically a recipe for disaster, as the prices of investments are increased by competing bidders (including other LGPS funds and pools) and returns are subdued. In worst-case scenarios, overly risky investments could be made to meet targets, only to then disappoint/fail, with significant losses for investors.

One step government is taking to help with this is launching the National Wealth Fund (NWF). This is seeded by money from the UK Infrastructure Bank, plus some additional investment from the UK government, and will act as a facilitator of investment. It will look to help make UK investment opportunities more palatable for other investors, like the LGPS, by taking a larger share of the investment risk (particularly in early stages), so that other investors can take safer positions in the investment.

Whether this will be enough to avoid the over-valuation of UK investments is unknown, and the NWF doesn't address all of the issues set out in the Call for Evidence responses. Similarly, if the NWF does make UK investment more attractive, it will do so for a wider range of investors than the LGPS, meaning there may still be bidding wars and struggles to meet possible targets for the LGPS.

What should you do about it?

While significant amounts of information would need to come, we think there are some sensible actions that could be undertaken over the next six months to help to prepare for this new challenge. Depending on the details to come, some will be more applicable than others. However, it's worth planning for these eventualities.

Measure your current UK exposure – not just to show the government how much you already hold, but to help inform where new allocations should go. Many funds will be invested in UK projects without necessarily knowing about it, as the investment was made through a global fund. You'll want to avoid overinvesting in certain areas of the UK market and look to opportunities you're not yet exposed to.

Undertake training – this will most likely entail investing in new markets, asset classes and funds managed by new investment managers. It's therefore imperative that a strong understanding of these is gained in order for decisions to be made from a well-informed position.

Review your beliefs – it's important to understand how your pensions committee feel about this change. Is this something you're enthusiastic about? Do you want to use this as an opportunity to have a positive impact on the UK? Or is it a tick-box exercise. Do you want to implement this nationally, or have a local bias? What does "local" mean to you? This will have material impact on how you go about implementing this.

Consider your wider strategy – the size of the task ahead depends on how much new money the government want you to invest in the UK and how quickly. If this is going to be very disruptive to your strategy – needing a lot of change and quickly – it will warrant a review of your whole strategy. Strategy reviews have developed over the years. Historically based on finding the most efficient way of achieving your appropriate levels of risk and return, these increasingly reflect other requirements, such as Net Zero ambitions. Now, this UK allocation requirement will be another factor to be reflected, while ensuring you still expect to achieve your required rates of return within tolerable levels of risk.

Engage with your pools – and your partner funds. Agree what your pool can do to help you to invest in the UK and what your pool has planned, whether that is specific UK funds, single or multi-asset class, or ensuring all of their current and future funds have a strong UK bias.

What's next?

Whether UK investment is mandated or strongly encouraged, this creates a new challenge for the LGPS. We know for many funds, having government direction on this issue is in some ways positive.

While we're waiting for details from government on what it will require, there's still plenty you can do to begin preparing. In these initial phases, we believe funds should be making a plan over the next six months, which covers measurement of current UK exposure, undertaking training and possibly reviewing beliefs. These will form a strong basis for the implementation of whatever comes next.

If you have any questions, or would like to discuss anything further, please get in touch.