TEESSIDE PENSION FUND

Administered by Middlesbrough Council

AGENDA ITEM 8

PENSION FUND COMMITTEE REPORT

16 MARCH 2022

DIRECTOR OF FINANCE – IAN WRIGHT

Update on Current Issues

1. PURPOSE OF THE REPORT

1.1 To provide Members of the Pension Fund Committee (the Committee) with an update on current issues affecting the Pension Fund locally or the Local Government Pension Scheme (LGPS) in general.

2. RECOMMENDATIONS

2.1 That Members note this report.

3. FINANCIAL IMPLICATIONS

3.1 There are no specific financial implications in respect of the information contained in this report.

4. LGPS AND 'LEVELLING UP'

4.1 As Members may be aware, the Government published its "Levelling up the United Kingdom" White Paper on 2 February 2022. The full 332 page document along with a 17 page Executive Summary can be found at the following web page:

https://www.gov.uk/government/publications/levelling-up-the-united-kingdom

4.2 The scope of the White Paper is broad: its stated objective is to take radical steps to improve UK prosperity by "tackling the regional and local inequalities that unfairly hold back communities and to encourage private sector investment right across the UK". The White Paper covers a lot of ground, including twelve "ambitious medium term" levelling up "missions" grouped under one of four headings. For example (from page 6 of the Executive Summary) under the heading "*Boost productivity, pay, jobs and living standards by growing the private sector, especially in those places where they are lagging*" there are three "missions" including "By 2030, pay, employment and productivity will have risen in every area of the UK, with each containing a globally competitive city, and the gap between the top performing and other areas closing."

4.3 Within the section on boosting productivity etc. the White Paper includes the following statement about the role the Local Government Pension Scheme will be expected to play:

"Levelling up requires mobilising previously underutilised sources of capital. That is why we're using the tax system to incentivise private sector investment, through Freeports, Enterprise Zones and the Super-deduction. It is also why the Prime Minister and Chancellor have called on the UK's institutional investors to seize the moment for an "Investment Big Bang" to boost Britain's long-term growth. The UK Government will go further and work with **Local Government Pension Funds to publish plans for increasing local investment, including setting an ambition of up to 5% of assets invested in projects which support local areas.**"

4.4 A number of similar references to Local Government Pension Scheme (LGPS) Funds being used to support 'local investment' are included elsewhere in the White Paper, including the following:

"There are large pools of underutilised capital across the UK that could, in principle, be used to support investment. For example, Local Government Pension Funds have assets with a combined market value of £326bn as of March 2020. Only a few funds have so far invested with a local, place-based lens. As discussed further in Chapter 3, there is huge scope to mobilise more financing from UK institutional investors in local projects. Regulatory steps are now being taken to do so."

(Full report: page 68 – page 100 of the PDF)

"Unlocking institutional investment

The case for action

There is huge potential for institutional investment to support levelling up, across infrastructure, housing, regeneration and SME finance. Institutional investors currently hold UK pension assets of over £3.5tn. Within that, the Local Government Pension Scheme (LGPS) has total investments of over £330bn, making it the largest pension scheme in the UK. Only a tiny fraction of these funds are currently allocated to local projects. If all LGPS funds were to allocate 5% to local investing, this would unlock £16bn in new investment.

The policy programme

The UK Government has committed itself to removing obstacles and costs to making long-term, illiquid investments in the UK. LGPS funds are investing in a wide range of existing UK and global infrastructure, largely through the eight LGPS asset pools. A dedicated infrastructure platform (GLIL) has been established jointly by the Northern and Local Pensions Partnership Investments and LGPS asset pools, and has around £2.5bn committed, with investments including Anglian Water, Forth Ports (including Tilbury) and Clyde Windfarm.

Infrastructure investment by the LGPS has grown from under £1bn in 2016 to £21bn in 2021. To build on this established capacity and expertise, and ensure that all LGPS funds play their full part, the UK Government is **asking LGPS funds, working with the LGPS asset**

pools, to publish plans for increasing local investment, including setting an ambition of up to 5% of assets invested in projects which support local areas.

The new UK Infrastructure Bank, based in Leeds, has a mandate to catalyse investment to support regional and local economic growth, and will help increase the capacity and capability of local authorities to deliver infrastructure in their areas. It will also co-invest, offer guarantees through the existing UK Guarantees Scheme, and provide a range of debt, equity and hybrid products. It is committed to expanding institutional investment in UK infrastructure, including exploring opportunities with the LGPS."

(Full report: pages 162 and 163 – pages 194 and 195 of the PDF)

4.5 The detail of the White Paper's aims in respect of LGPS investment in local areas is expected to be included in a forthcoming consultation document expected later in the year. There are some significant issues that need clarifying, including:

- How will "projects which support local areas" be defined? The reference to involving the asset pooling companies in this local investment approach suggests that 'local' may actually just mean 'within the UK' rather than within the confined geographical area covered by a particular LGPS Fund. This could mean, for example, a 'local' or 'impact' investment fund set up by Border to Coast could contain a mixture of assets located across its Partner Fund's localities – from Cumbria to Surrey.
- What assets will be included as 'local' (or perhaps 'UK') investments for the purposes of measuring against the 5% target? Infrastructure and private equity investments are likely to have a meaningful impact on a local area so will probably be included. What about public equities? – if an LGPS Fund or LGPS Pool owns public equity in a company that is engaged in carrying out activity that 'levels up' a local UK community, will this count?
- What approach will be taken to LGPS Funds' existing investments when determining whether the 5% local investments target has been met? It seems likely that the government is looking for an *extra* 5% of Funds to be invested locally, so existing local investments would not count in the assessment – this seems a little unfair to Funds that have already made efforts in this area.
- Most importantly, what level of compulsion will there be for Funds to invest 'locally'? LGPS Funds have a fiduciary duty to invest their funds appropriately for the benefit of their beneficiaries. Up until now, this duty has been the most important one Funds have to consider when making asset allocation decisions. If the government is seen to be explicitly directing how LGPS Funds invest, this will be controversial and will presumably require legislation. The wording of the White Paper indicates the government may not be looking to be completely directive in this area: for example the White Paper refers to setting "an ambition" (not a target) of "up to 5% of assets invested in projects which support local areas".

4.6 Since 2016 the Pension Fund has put in place a protocol to enable local investment opportunities to be considered and, where suitable, approved by the Pension Fund

Committee. The Fund defines "local" within the context of its own geographical area, so local investments in this context are those within the Teesside area (the areas covered by Hartlepool, Middlesbrough, Redcar & Cleveland and Stockton-on Tees Councils).

4.7 The Fund's investment approach allows up to 5% of its assets to be invested in local projects. One of the important criteria for assessing any potential local investment is to ensure it has the right risk and return characteristics to meet the Fund's financial objectives. Any local investment in itself needs to generate an acceptable economic return for the Fund. The Fund cannot factor into its calculations secondary benefits, such as social or any other non-economic benefits that do not provide direct investment return. Having an appropriate governance structure around the investment is also very important, as is the need for the Fund to acquire and act on appropriate specialist advice as required when deciding whether to progress with a local investment.

4.7 Over the last six years the Fund has made a total of £41m in commitments to the following three ongoing local investments with different risk / return profiles – GB Bank, The Ethical Housing Company and WasteKnot. This commitment represents around 0.8% of the Fund's assets (based on the Fund's 31 December 2021 valuation). This is some way short of our 5% potential local investment allocation, and this reflects in part the difficulty of sourcing appropriate local investments for the Fund within the Teesside area.

4.8 A consultation document is expected later in the year which should provide more clarity on the government's "ambition" for LGPS Funds to invest 5% of their assets in projects that support "local areas", and on whether this will be implemented through statutory guidance or legislation.

5. GOVERNMENT ACTUARY'S DEPARTMENT SECTION 13 REPORT – MAIN FUNDINGS

5.1 On 16 December 2021 the Government Actuary's Department (GAD) published its Section 13 Report on the actuarial valuations carried out across the LGPS as at 31 March 2019.

5.2 The Report is named after Section 13 of the Public Service Pensions Act 2013 which requires the government to commission a report after each triennial valuation to assess whether the following four aims have been achieved: compliance, consistency, solvency and long term cost efficiency. The Report is broadly positive about the LGPS and acknowledges that since the 31 March 2016 valuation market value of the scheme's assets increased from £217 billion to £291 billion and its aggregate funding position "on prudent local bases" has increased from 85% to 98%. GAD does add a note of caution about potential funding issues in the future: "the size of funds has grown significantly over the three years to 31 March 2019. However, the ability of tax backed employers to increase contributions if this was to be required (as measured by their core spending power) has not kept pace. This could be a risk if, for example, there was to be a severe shock to return seeking asset classes."

5.3 As regards the four aims, this is a summary of the report's findings:

5.3.1 Compliance

Fund valuations were compliant with relevant regulations, although more clarity on the assumptions used to determine employer contributions in the Rates and Adjustments certificate for some Funds would be helpful.

5.3.2 Consistency

There was greater consistency and better presentation of information in Fund's valuation reports than in the 31 March 2016 reports. Some areas of inconsistency remain which GAD believes should be addressed, leading to the Report's first recommendation:

"**Recommendation 1:**

The Scheme Advisory Board should consider the impact of inconsistency on the funds, participating employers and other stakeholders. It should specifically consider whether a consistent approach needs to be adopted for conversions to academies, and for assessing the impact of emerging issues including McCloud."

5.3.3 Solvency

GAD describes this in relation to setting an employer contribution rate. This rate is appropriate if the rate of employer contributions is set to target a funding level for the whole fund of 100% over an appropriate time period and using appropriate actuarial assumptions and either:

- employers collectively have the financial capacity to increase employer contributions, should future circumstances require, in order to continue to target a funding level of 100%

or

- there is an appropriate plan in place should there be an expectation of a future reduction in the number of fund employers, or a material reduction in the capacity of fund employers to increase contributions as might be needed

As Funding levels have improved between the 2016 and 2019 valuations, many LGPS Funds have reduced employer contribution rates. GAD believes this has not been the right approach: "In GAD's view, the prevailing economic conditions have deteriorated between 2016 and 2019. Many funds have reduced their contribution rates as a result of the improvement of their funding position. In our opinion, for some funds, the deterioration in economic conditions may have warranted a strengthening of the valuation basis, resulting in a requirement to maintain or increase contributions."

GAD highlights the growth in pension fund assets has not been matched by a growth in the size of the scheme's employers, leading to a growing mismatch which could cause problems in the event of a future asset shock. The report makes the following statement, whilst acknowledging that administering authorities and their advisors are likely to already be aware of it:

“**General risk comment**

Local authorities have finite resources and in recent years the size of pension funds has increased considerably more than local authority budgets. Given that pension funding levels change it is not unlikely that a period of increased pension contributions may be required at some point in the future.

If additional spending is required for pension contributions this may lead to a strain on local authority budgets.

We would expect that administering authorities are aware of this risk in relation to solvency and would monitor it over time. Administering authorities may wish to discuss the potential volatility of future contributions with employers in relation to overall affordability.”

5.3.4 Long term cost efficiency

GAD makes an assessment as to whether each LGPS Fund has set employer contributions at the right level to ensure long term cost efficiency, meaning contributions are set at a rate sufficient to cover the cost of current benefit accrual with an appropriate adjustment to that rate for any surplus or deficit in the Fund. GAD have flagged four Funds as raising concerns following their long term cost efficiency assessment. GAD also make the following recommendations in relation to the presentation of deficit recovery plans and how that changes over time, together with a final recommendation around councils that have (in some Funds) made asset ‘gifts’ to their Funds to ensure these approaches are sufficiently assessed to ensure inter-generational fairness:

“**Recommendation 2**:

We recommend the Scheme Advisory Board consider how all funds ensure that the deficit recovery plan can be demonstrated to be a continuation of the previous plan, after allowing for actual fund experience.

Recommendation 3:

We recommend fund actuaries provide additional information about total contributions, discount rates and reconciling deficit recovery plans in the dashboard.

Recommendation 4:

We recommend the Scheme Advisory Board review asset transfer arrangements from local authorities to ensure that appropriate governance is in place around any such transfers to achieve long term cost efficiency.”

6. GOVERNMENT ACTUARY’S DEPARTMENT SECTION 13 REPORT – FUND COMPARISONS

6.1 In producing the Report GAD compares each LGPS Fund’s 31 March 2019 valuation on a single standard basis which is typically less prudent that the Fund’s own basis but allows better comparison between Funds.

The full report and accompanying appendices can be found at the following web page:

https://www.gov.uk/government/publications/local-government-pension-scheme-review-of-the-actuarial-valuations-of-funds-as-at-31-march-2019

An extract from the Report's appendix including several relevant graphs is enclosed as Appendix A.

6.2 The main points to note from the comparison graphs are as follows (these comparisons all relate to the results of the last actuarial valuations of the LGPS Funds in England and Wales, as at 31 March 2019):

- The Fund had the second highest funding level in the LGPS on a 'local valuation' basis but was only the twentieth highest on a Scheme Advisory Board standard basis.
- The Fund has the sixth smallest percentage difference between the funding level it reported in its valuation report and the standard basis funding level.
- The Fund had the 22nd highest pre-retirement discount rate and the 10th highest assumed asset outperformance within its discount rate. This is an assessment by GAD of the degree of investment return the Fund is assuming compared with 'risk-free' (government bonds) investment taking inflation into account.

6.3 These points indicate that the Fund may have probability of funding success that could be lower than average, and may also be anticipating a higher return from its assets than the average LGPS Fund. However this needs to be considered in the context of the Fund's asset mix which, at the last valuation, was significantly more heavily weighted towards equities than the average LGPS Fund.

6.4 By its nature, GAD's Report is primarily backward looking, although the recommendations will be considered and taken into account, where relevant, by the Fund's actuary as the 31 March 2022 valuation is undertaken.

7. TRIENNIAL ACTUARIAL VALUATION AS AT 31 MARCH 2022

7.1 2022 is a valuation year for the LGPS. Every three years the Fund's assets and liabilities are valued as at the 31 March by the Fund actuary, with the resulting report (expected to be published in final form in March 2023) showing the Fund's funding level and setting employer contribution rates for the next three years from 1 April 2023 onwards.

7.2 The Fund, in common with the rest of the LGPS, is a long term investor, whose pension liabilities are largely backed by secure employers with very strong covenants. This means the actuary is able to take a long term view when setting the financial and demographic assumptions for the valuation. However shorter term volatility in asset values has to be recognised as part of the valuation process, and the starting point for the valuation will be the actual market value of the Fund's assets on the valuation effective date (31 March 2022).

7.3 The Fund has recently appointed Hymans Robertson as its actuary after a tightly contested procurement process. Hymans Robertson were appointed from 1 January 2022 and have been working with Pension Fund officers and with XPS to ensure there will be smooth exchange of data required for the valuation, and to finalise a valuation timetable.

8. DEPARTMENT FOR WORK AND PENSIONS (DWP) CONSULTATION ON THE DRAFT PENSIONS DASHBOARDS REGULATIONS 2022

8.1 On 31 January 2022 the DWP published a consultation document on draft regulations designed to implement pensions dashboards. The consultation documents can be found at the following web page:

https://www.gov.uk/government/consultations/pensions-dashboards-consultation-on-the-draft-pensions-dashboards-regulations-2022

8.2 Pensions dashboards will be an internet-based service which will allow individuals to access information about their pensions, ideally from all sources (private sector, public sector and state pension) all in one place. The intention is that "Pensions dashboards will put individuals in control of planning for their retirement by bringing together their pensions information from multiple sources, including information on their State Pension, which can then be accessed at a time of their choosing."

8.3 The consultation and the draft regulations set out what steps pension schemes and dashboards will be required to take, and proposes introducing the obligation to connect with and supply data to the dashboards systems. This is expected to happen in a staged way starting from April 2023 - public service pension schemes (including the LGPS) "should be compelled to connect no earlier than October 2023".

8.4 The consultation sets out details of the type and format of data pension schemes and dashboard providers will be required to use to validate and process requests from scheme members, along with the penalties possible for those organisations for non-compliance.

8.5 The type of information the LGPS will initially be expected to provide on a pensions dashboard is similar to that already provided through annual benefit statements. However the introduction of pensions dashboards may increase interaction with scheme members, as well as putting even greater emphasis on the importance of data quality and timely processing.

8.6 Consultation responses are required by 13 March 2022. The Local Government Association (LGA) has said it will prepare a response to the consultation and will share this with LGPS Funds prior to the response deadline. The Head of Pensions Governance and Investments will consider whether a separate response is required from the Fund and, if so, will submit this after consultation with the Chair and Vice Chair of the Pension Fund Committee.

9. PUBLIC SERVICE PENSIONS AND JUDICIAL OFFICES BILL - AMENDMENT

9.1 The Government is progressing a bill through parliament, the Public Service Pensions and Judicial Offices Bill, designed primarily to remove unlawful discrimination in the protections introduced when public sector schemes were changed in 2014 and 2015. MP Robert Jenrick proposed an amendment to the bill which, supported by the government, was subsequently accepted which will add an additional unconnected provision that directly affects the LGPS.

9.2 The amendment changes the Public Service Pensions Act 2013 to give the Secretary of State the explicit power to issue to administering authorities “guidance or directions on investment decisions which it is not proper for the scheme manager to make in light of UK foreign and defence policy.”

9.3 Clearly, it is disappointing that the amendment to this Bill allows the Secretary of State to gain potentially significant additional power to direct how LGPS funds can invest without allowing appropriate consultation with the LGPS itself. Also, without sight of the guidance, it is not clear how this new power would work – what exactly is an “investment decision which it is not proper for the scheme manager to make in the light of UK foreign and defence policy”?

9.4 More information on this issue will be presented to the Committee as and when it becomes available.

10. NEXT STEPS

10.1 Further updates will be provided periodically.

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