Middlesbrough
moving forward

Pensions Governance and Investments

29 September 2023

LGF Pensions Team
Department for Levelling Up, Housing and Communities
By email to LGPensions@levellingup.gov.uk

Dear Sir or Madam,

Local Government Pension Scheme: Next steps on investments

Middlesbrough Council welcomes the opportunity to comment on the proposals in the consultation "Local Government Pension Scheme (LGPS): Next steps on investments".

Middlesbrough Council is the Administering Authority for the Teesside Pension Fund (the Fund) which is part of the LGPS. The Fund has assets of around £5 billion and has over 170 employers.

In 2018, Middlesbrough Council's jointly owned pooling company, Border to Coast Pensions Partnership Limited (Border to Coast) began managing investments on behalf of its eleven Partner Funds. The Partner Funds came together with an agreed set of principles that continue to guide how we work together. Together we are delivering against Government's original pooling policy objectives:

- over £40 billion pooled through Border to Coast, with clear plans to increase this in the years ahead;
- £65 million of cost savings delivered to 31 March 2023, with expectations to increase this to £340 million by 2030;
- facilitating investments in wider range of assets at scale, in asset classes such as private equity and infrastructure, part of which is delivering growth capital across the UK.

Border to Coast adds significant value to the Fund above and beyond the original pooling objectives, particularly in relation to responsible investment. They have built a centre of expertise, taking the lead on behalf of Partner Funds on active stewardship on climate change and other issues, and working collaboratively with groups such as Climate Action 100+ to deliver real world change.

Over 80% of the Fund's listed assets, and a significant proportion of the Fund's unlisted investments are also managed by Border to Coast. Plans are in place for the transfer of assets to continue in the coming years, as investment funds are launched following approval by the FCA.

Any evolution of the arrangements for pooling investments should be consistent with our fiduciary responsibility to set an investment strategy which will deliver the pension promise for our scheme members and ensure that contributions for scheme employers remain stable and affordable.

Given the importance of governance to the successful delivery of the Government's policy objectives in this consultation, it is regrettable that there has not been a response to the Scheme Advisory Board's (SAB) recommendations in relation to the Good Governance Project. Concluding this work would have addressed some of these objectives.

Question 1: Do you consider that there are alternative approaches, opportunities or barriers within LGPS administering authorities' or investment pools' structures that should be considered to support the delivery of excellent value for money and outstanding net performance?

The ecosystem in which the LGPS operates is changing and it is important to acknowledge and adjust to this, to ensure we can continue to collectively deliver for LGPS members. This includes dealing with the increasing regulatory and governance complexity and the burden on individual Funds.

This challenge can be addressed through:

- engaged and informed Pension Committees and Local Pension Boards, exhibiting an appropriate level of knowledge, understanding and professionalism. They should be supported by experienced officers, exclusively dedicated to the Pension Fund, with the right resources to develop oversight arrangements of the investments
- appropriately resourced pools, which can support the development and implementation of the investment strategies of their Partner Funds. As centres of expertise these pools can provide wider support for Partner Funds

In operating any system, good governance is fundamental. This can cover a wide range of issues, but includes the establishment of clear divisions of responsibilities, robust oversight and simplified, flexible decision-making, including effective delegations to specialists trusted to exercise sound judgement over the long-term. The importance of this is often underestimated.

The "governance premium" is thought to be around 0.6% per annum additional return and has been estimated as high as 1-2% per annum. This is evidenced[1] via asset owners with "good governance". This relates primarily to the delegation of operational investment decision-making with strong oversight and scrutiny by the asset owning body. It is based on research over the last 20 years. We recognise that standards are variable, with smaller funds less likely to rate themselves as highly on important measures of quality. While each fund and pool should consider their own governance frameworks, progress on the 'Good Governance' review will support the LGPS and progress would therefore be welcomed by all[2].

Scale can deliver significant benefits. A 2022 publication[3] by CEM looked at the case for scale for pension schemes. Its findings were that asset pooling led to lower staff costs per assets invested due to the ability to internalise certain investment capabilities, and to lower external management fees due to the negotiating strength that comes from the value of mandates being placed, negotiated by professional investors whose interests are fully aligned with the ultimate asset owners.

However, scale doesn't always deliver additional benefits; seeking scale without addressing issues such as good governance, management of conflicts of interest, a common vision and culture (within the Pool and among Partner Funds), complexity of investment strategies, and client needs, can either inhibit, or damage, a pools ability to deliver.

Delivering the benefits of pooling can be challenging and requires an understanding at officer and elected member level of both the benefits and costs of compromise, and an ability to assess where such compromise does not have a material impact on the risk/return profile that the Partner Fund wishes to achieve.

Given the potential benefits of scale, it's important to consider the entire LGPS ecosystem. A key point for Funds is the need for appropriate capacity and capabilities to deliver their objectives. In this context, further consolidation could be considered.

In considering the LGPS ecosystem and ensuring that good outcomes are delivered it is important to recognise and manage the potential conflict of interests that both investment consultants and pools may have in providing investment advice to Funds.

We have seen greatest success when there is a positive presumption towards pooling. In this situation the benefits that come from pooling, in both investment outcomes and reduced ongoing governance and advisory costs are considered.

2. Do you agree with the proposal to set a deadline in guidance requiring administering authorities to transition listed assets to their LGPS pool by March 2025?

We support the principle of transferring assets to pools, including having a clear path to transition. Each funds' Investment Strategy Statement (ISS) should include a transition plan for listed assets to be transferred to the pools, as well as the composition and justification of any assets remaining outside the pool.

Partner Funds have already transferred most of their assets to Border to Coast. Further transfers are planned over the next few years. Each transfer event typically requires the launch of an investment fund, the development of which takes six to twelve months including receiving approval by the FCA. Resources to develop new funds are limited and imposing an arbitrary timescale could lead to hasty fund launches of sub-optimal investment funds.

Many Funds (including ours) hold some listed assets that are invested passively outside of the pool. It is important that Funds should retain the ability to choose whether to invest actively or passively in certain markets. Over recent years, mainly due to the joint working and collaboration achieved through pooling, the cost of investing passively has reduced significantly and the actual investment is carried out very efficiently and cost-effectively through a number of large private sector investors. It is not clear what cost savings (if any) would result in requiring 'standard' passive equity investment to be carried out by LGPS pools, instead it could incur transition costs and introduce execution risk.

We would welcome clarity on the position of legacy illiquid assets such as private equity and infrastructure. Fees were negotiated at the commencement of each investment and there is no ability to subsequently adjust them. Transferring these assets to the pool would incur unnecessary significant legal and tax costs. Specific barriers are in place in relation to the transfer of property assets from a Fund to a pool. At present, there is only a narrow time-window in which such assets can be transferred without incurring punitive tax charges – it would encourage asset transfer if this window of opportunity could be extended.

Question 3: Should government revise guidance so as to set out fully how funds and pools should interact, and promote a model of pooling which includes the characteristics described above?

Through Border to Coast we have developed a model of pooling which has successfully allowed us to meet the government's objectives for pooling. We support the approach set out in the consultation, which reflects how we have sought to pool. Nevertheless, we would urge caution on being overly prescriptive in describing any model in guidance as this may stifle innovation and the ability of Partner Funds and pools to respond to changing circumstances.

Administering Authorities are responsible and accountable for their investment strategies. A pool such as Border to Coast can play a significant role in supporting their development. However, robust governance arrangements need to be in place to manage potential conflicts, and to ensure proper oversight and scrutiny by Partner Funds can take place.

Question 4. Should guidance include a requirement for administering authorities to have a training policy for pensions committee members and to report against the policy?

The key to a successful approach is ensuring decisions are made by the right people, with the right level of knowledge, at the right time.

It is important that there is local accountability for target returns, risk appetite, and investment beliefs that underpin the investment strategy to deliver cost effective and sustainable pensions.

As outlined in the consultation, and something we support, the role of a Pension Committee is to review and approve the investment strategy, and to provide oversight and scrutiny on how it is being executed. To be effective in this role, Committees will need to have in place appropriate support and delegate functions to officers who have sufficient experience and knowledge to support the Committees. In turn, Pension Committees and their officers can be supported by the centre of investment expertise that resides in the pool that they own, which is also responsible for the implementation of Funds' investment strategies.

The knowledge and understanding of Pensions Committees may be supported by independent advisors who can act in a role similar to Non-Executive Directors. With clear objectives, they may play a key role in supporting Committees in their responsibilities for oversight and scrutiny of the implementation of the investment strategy by the pool.

For Pension Committees, a key component to this is an effective training policy, reported against as part of clear delegation of functions between Committees and officers. This is something the Fund manages in a structured way.

We recognise the difference in the current training requirements between Pension Committees and Local Pension Boards. We believe it is appropriate that the requirements for sitting on a Pension Committee should at least match that for membership of a Local Pension Board.

We believe Government proposals in relation to the interaction of pools and funds, and the training of pension committee members, should be addressed as part of a holistic response to the Good Governance Project report completed by the SAB to ensure changes take place within a framework focused on delivering the best outcomes for LGPS members.

Question 5. Do you agree with the proposals regarding reporting? Should there be an additional requirement for funds to report net returns for each asset class against a consistent benchmark, and if so how should this requirement operate?

We support the proposal to have standard reporting requirements with clear and consistent definitions. We would welcome this being progressed as part of the Good Governance Project. We would also welcome a complete review of the regulations to simplify and streamline processes.

While supporting reporting net savings, this needs greater consideration, specifically "against what?". In calculating our savings, we are comparing our current position with data from 2015/16 which does not reflect the market pricing we see today. This information has become dated and is arguably irrelevant. Equally, a focus on cost may also drive unintended consequences, particularly given the desire from Government to increase investment in more expensive asset classes, such as private equity. As the pooling journey continues, it may be appropriate to use other reporting mechanisms.

We have significant concerns on the proposals to produce standard reporting on investment returns. Each individual fund has its own investment strategy and risk appetite. Even within a single pool, two funds may superficially have similar investment strategies, but they may be seeking to deliver significantly different outcomes. There is a danger that returns reported against an inappropriate benchmark are taken out of context and could lead to poor investment decisions being made.

Question 6. Do you agree with the proposals for the Scheme Annual Report?

We support clear and consistent reporting by the SAB, provided the Board is sufficiently resourced to undertake the work and it is undertaken in such a way as to minimise the data collection burden on funds.

We also note the broader issue of increased reporting for the LGPS. The research in "LGPS: Views from inside the scheme" found that over half (54%) of respondents feel that the legislation/regulatory requirements are too complex to execute, while two in five (43%) continue to feel legislation/ regulatory requirements hinder them from doing their job effectively.

This is not to diminish the fundamental role of transparency and reporting. This is essential to ensure accountability, and to drive best practice across the LGPS. However, simplicity is key. Partly driven by the scale and complexity in current reporting requirements, we understand a recent review by SAB suggested that nearly a third of LGPS funds were not meeting their annual report disclosure requirements.

Simply adding additional reporting requirements not only adds cost, but there is a significant negative impact for the intended audience of the scheme members due to the volume and complexity of information being published. We believe that the impact assessment of changes in guidance, in terms of cost, transparency, and in the ability of readers to interpret what is shared, should be taken in the context of the ongoing review of LGPS reporting requirements being undertaken by the SAB.

Question 7. Do you agree with the proposed definition of levelling up investments?

Yes, however levelling up investments should only be made where they are consistent with the investment strategies of LGPS funds. Through Border to Coast a new private markets strategy, 'UK Opportunities'[4] is being developed. Set to launch in April 2024, we believe this will provide the Partner Funds with opportunities to invest in the regions across the UK, including venture and growth capital, and will ultimately support the policy intent outlined in the Levelling Up white paper.

Under current guidance, individual funds have the flexibility to invest up to 5% outside the pool. The local and specific nature of these investments mean they may be of a small scale and unsuitable to be effectively managed through the pool. However, pools are well placed to advise and support individual funds in this regard. Issues including resourcing and managing conflicts of interest will need to be carefully addressed. We believe the exemption to making these investments outside of the pool should be maintained.

Question 8. Do you agree that funds should be able to invest through their own pool in another pool's investment vehicle?

Collaboration has been, and should continue to be, a hallmark of strength in the LGPS.
If a pool is unable to effectively develop and manage an investment proposition, there may be merit in sourcing this capability through another LGPS pool. However, there are implications that need to be recognised. These include issues such as:

- Border to Coast investment funds are designed with, and for, 11 Partner Funds who are both shareholders and customers. Care will be required should external pool customers wish to invest in them. The existing governance structures and processes will need to be reviewed to overcome this challenge.
- Certain investments may have capacity issues. For example, the first Climate Opportunities fund launched by Border to Coast was capped at £1.35bn, which reflected the availability of suitable market opportunities. The demand from Partner Funds was significantly above this

figure. Care will be required in balancing the needs of shareholder customers against those of external pool customers for capacity constrained investments.

- As shareholders, existing Partner Funds principally manage risk through Border to Coast's regulatory capital. Different arrangements would need to be developed for non-shareholder external pool customers.
- In owning and building Border to Coast, there has been a structured approach to its growth, building capacity and capability to reflect Partner Funds long term needs. This is likely to be absent with non-shareholder customers, where there is the added risk of managing inflows and outflows of capital. This could destabilise the ability to plan the required capacity in various parts of the business.

Management of additional customers would require careful consideration, particularly noting the potential additional layer of due diligence costs that would be required as a regulated asset manager investing into another regulated asset manager's vehicle.

Nonetheless, if these issues are overcome, it could be easier to manage this on a pool-to-pool basis, than an individual fund-to pool basis.

Question 9. Do you agree with the proposed requirements for the levelling up plan to be published by funds?

The objective of all LGPS Funds is to generate the appropriate risk adjusted returns to ensure they can operate the LGPS in an affordable and sustainable manner.

Where ancillary objectives (such as those outlined in the Levelling Up White Paper) can be co-delivered without impacting these returns or increasing risk, this is to be welcomed. Levelling Up, effectively delivered, has the potential to create growth; including creation of jobs, drive productivity, improve people's quality of life and better health and wellbeing outcomes.

Nonetheless, LGPS assets are invested to deliver appropriate risk adjusted returns and should not be used to implement any Central Government policy objective – no matter how laudable it may be. We welcome the recognition in the consultation that each Partner Fund is responsible for setting their investment strategy, designed to deliver the appropriate risk adjusted returns they require.

Any investment strategy and associated reporting on Levelling Up needs to be through the principal asset classes (e.g. Real Estate, Private Equity, Infrastructure, Private Credit, etc). This ensures that the risk adjusted returns are considered on the same basis. This can be reported via a Fund's Investment Strategy Statement. Investments which support the policy intent of the Levelling Up White Paper should be reported as a memorandum item.

Border to Coast has announced plans to launch a 'UK Opportunities' strategy as part of its private markets programme, designed to provide attractive risk adjusted investment returns to Border to Coast's 11 Partner Funds. It will be a multi-asset UK strategy investing in areas such as Corporate Financing, Housing, Property, Infrastructure, Renewables, and Social Bonds.

The nature of underlying investments should result in a range of positive impacts, which could include jobs created, new housing units delivered (residential, affordable, social, assisted), new commercial floor space, delivery of local infrastructure, renewable energy capacity, the provision of training including apprenticeships.

Subject to ongoing engagement with Partner Funds, 'UK Opportunities' will be launched in April 2024.

Question 10. Do you agree with the proposed reporting requirements on levelling up investments?

We are comfortable with the proposals, albeit we note that this again expands the reporting and regulatory requirements on Funds, which will have resource implications.

Question 11. Do you agree that funds should have an ambition to invest 10% of their funds into private equity as part of a diversified but ambitious investment portfolio? Are there barriers to investment in growth equity and venture capital for the LGPS which could be removed?

Administering Authorities remain responsible for their investment strategies. As open defined benefit pension schemes, it is essential that we adopt appropriate diverse investment strategies designed to balance risk and return, to ensure the LGPS remains affordable. It is not appropriate for government to determine the asset allocation approach LGPS funds should take by, for example, directing 10% should be invested in private equity, 5% in levelling up, x% in infrastructure etc. Government can encourage, facilitate and (perhaps) support investment in the asset classes it believes will help achieve its goals, but ultimately Administering Authorities should be making asset allocation decisions, taking into account their overarching fiduciary duty to their stakeholders.

As part of this approach, private markets can play an important role. Our Fund's investment includes an allocation to private markets of 20% excluding property, which has a separate weighting of 10%. Asset pooling in general, and Border to Coast in particular has improved the Fund's ability to access this asset class effectively and efficiently. It is important to note that private markets investments come with risks as well as opportunities – by their nature they are often less transparent, less liquid, more expensive than public markets and are slower to be repriced. They do not necessarily perform well under all market conditions, and there is a risk the benevolent market conditions of the previous decade may have flattered outcomes in some private funds.

We note the reference to private equity, growth equity and venture capital. This is a narrow part of the market. Early-stage growth, especially that focused on technology, is relatively high risk. For investors who have not made any previous or meaningful commitments to private capital more broadly, this is a challenging entry point and risks volatile returns or losses which would be likely to discourage future investment in private markets.

A broader definition, covering 'private capital' allows investors to build private market risk appetites which suit their own circumstances, rather than pushing everyone to a more narrowly defined and therefore potentially crowded part of the market with volatile returns.

Using this broader definition, our Fund already exceeds the aspiration to invest 10% of our assets in this area. Recognising our current extensive UK investment exposure, in seeking appropriate and diverse investment opportunities, exposure to this type of investment should be global in nature.

The most effective way to encourage any investment in the UK is the provision of a stable investing environment through policy certainty. If the LGPS and private capital is being asked to make large, long-term, capital investments the Government needs to offer corresponding long-term guarantees and the necessary policy certainty to protect these potential investors. Examples include policy certainty on renewable energy, transport and climate transition considerations; improvements to the planning regime to accelerate development opportunities, and to enable clearer partnership opportunities with Local Authorities; and the development of structures with the support of organisations such as the British Business Bank (BBB) and the UK Infrastructure Bank (UKIB) to enable risk sharing and return visibility.

While there is understandably a continued focus on costs, we recognise that private markets are more complex and expensive asset classes. Through Border to Coast, the Fund has access to the capability and capacity to access these markets in an effective and efficient manner.

Question 12. Do you agree that LGPS should be supported to collaborate with the British Business Bank and to capitalise on the Bank's expertise?

There is a range of potential partners that can support the LGPS pools to deliver growth capital in the UK. The BBB and the UKIB are two examples.

Given their state ownership and strategic focus to 'crowd in' other investors, these institutions may be well placed to support the LGPS pools to source and commit to ventures that meet their normal investment criteria.

We note that one of the key objectives of LGPS pooling was to reduce the fee burden paid by pension funds. In a private market context this included reducing the reliance on fund of fund structures which introduce an additional layer of fees. As such, any vehicle should be offered on a cost only basis if the intention is to encourage greater participation in this part of the market. An extra layer of fees will deter potential investors. BBB will be investing balance sheet capital into all investments, so a successful investment policy would deliver profitability for them without this fee income.

Question 13: Do you agree with the proposed implementation of the Order through amendments to the 2016 Regulations and guidance?

The Fund already sets strategic objectives for investment consultants, and we welcome its consistent application across the LGPS.

Question 14: Do you agree with the proposed amendment to the definition of investments?

Yes.

Question 15: Do you consider that there are any particular groups with protected characteristics who would either benefit or be disadvantaged by any of the proposals? If so please provide relevant data or evidence.

No.

Yours faithfully,

Councillor Julia Rostron
Chair of the Teesside Pension Fund administered by
Middlesbrough Council

References

[1] Pension Policy Institute: "Defined Benefits: the role of governance"
[2] The PLSA research, "LGPS: Views from inside the scheme" states that three-quarters of respondents believe government and regulators should focus on good governance (74%).
[3] A case for scale, February 2022
[4] https://www.bordertocoast.org.uk/news-insights/border-to-coast-marks-five-years-of-delivery/