

Response to LGPS Investment Regulations Consultation

Summary

- 1 Surrey welcomes the move from the arbitrary and prescriptive asset limits in the previous LGPS investment regulations, and the move towards prudential regulation. This will enable LGPS funds to effectively manage individual fund investment risk, thus meeting the specific needs of the scheme LGPS beneficiaries. Specific mention of the ultimate objective of the LGPS investment process to meet the ultimate needs of the LGPS beneficiaries would be a useful inclusion as this seems to have been overlooked. Additionally, the design and alignment of the investment strategy alongside the funding strategy would also be a useful mention.
- 2 The Government should also consider extending the knowledge and understanding requirements (currently falling only on Local Pension Boards) to the Scheme Manager/Pension Fund Committee. A prudent person requirement ultimately only works if those making investment strategy decisions have the knowledge, capacity and capability to achieve this.
- 3 Surrey has some concern about the broad powers being taken for the government to direct funds' investment processes. Such an encompassing power could ultimately be used by government to direct funds into specific asset classes with limited attention paid to the impact on the future payment of members' pensions. Moreover, a range of criteria or trigger points for government intervention should be considered.

Proposal 1: Deregulating and adopting a local approach to investment

Q1: Does the proposed deregulation achieve the intended policy aim of removing any unnecessary regulation while still ensuring that authorities' investments are made prudently and having taken advice?

The proposed deregulation is appropriate, particularly the removal of the prescriptive Schedule 1 of the Regulations, which no longer has any relevance.

The review of the Investment Strategy Statement should be consistent with the review of the Funding Strategy Statement, such that it can reflect the implications of the latest actuarial valuation and funding levels as they are monitored on a regular basis between valuation cycles.

Q2: Are there any specific issues that should be reinstated? Please explain why.

The proposed regulations appear to remove the requirement to state the extent to which a Fund complies with the Myners' Principles (Regulation 12(3)). The Myners' Principles are seen as best practice in investment management and it is appropriate that LGPS Funds continue to explicitly state the extent of their compliance with the principles. Inclusion of the principles and the "comply or explain" approach stated within the SIP is seen as the best way to achieve this.

Q3: Is six months the appropriate period for the transitional arrangements to remain in place?

The proposed timeframe for the transitional arrangements to remain in place would appear to be somewhat short. Surrey is concerned about the timescale for implementation which feels rushed, given the work commitment on the national asset pooling activity and the deadline for the proposal of 15 July 2015.

Q4: Should the regulation be explicit that derivatives should only be used as a risk management tool? Are there any other circumstances in which the use of derivatives would be appropriate?

In addition to maintaining risk management, derivatives can also be used for a number of reasons including efficient portfolio management purposes, e.g., in a transition process, obtaining immediate exposure to an equity market before completing the construction of an equity portfolio, or for pure return-seeking purposes.

The intention of the proposed changes to the existing LGPS regulations is for government to no longer be entirely prescriptive in terms of the types of investments available for Funds. Therefore, it would be more appropriate to permit the use of derivatives within an investment strategy and rely on the requirement for Funds to take an entirely prudential approach in ensuring the suitability of investments, appropriate diversification, and overall approach to managing risk.

Proposal 2: Introducing a safeguard (Secretary of State power to intervene)

Q5: Are there any other sources of evidence that the Secretary of State might draw on to establish whether an intervention is required?

The proposed power of intervention provides the Secretary of State with wide ranging powers to intervene in the operation of an individual LGPS fund, and this causes Surrey a degree of concern.

The Secretary of State would have to ensure consistency of application across different funds. For example, if a certain piece of evidence, e.g., performance data suggested that there should be an intervention at one particular fund, then this evidence should also be considered to determine whether an intervention is required at another fund. Failure to do this could lead to inconsistent, or even discriminatory, treatment across LGPS funds. It is recommended that a series of criteria/trigger points for intervention should be used as a framework for considering intervention.

Q6: Does the intervention allow authorities sufficient scope and time to present evidence in favour of their existing arrangements when either determining an intervention in the first place, or reviewing whether one should remain in place?

In the event that the Secretary of State is considering an intervention and gathering evidence, it is essential that this process should remain confidential in order to avoid adversely affecting the reputation of the administering authority before the intervention has been confirmed.

In addition to authorities being able to present evidence in support of their existing governance arrangements, they should also have full access to any evidence that the Secretary of State is using to determine whether an intervention is appropriate, prior to an intervention being determined. The authorities should have an appropriate length of time to consider this evidence with the opportunity to rebut the evidence or to introduce supplementary evidence to support a counter-argument to the evidence provided by the Secretary of State.

No timescales are laid down in the draft regulations and therefore it is not possible to comment as to whether authorities will have sufficient time to present evidence. However, it should be reiterated that the regulations should ensure that authorities have sufficient time to consider the evidence presented by the Secretary of State, as well as to present its own evidence.

Q7: Does the proposed approach allow the Secretary of State sufficient flexibility to ensure that he is able to introduce a proportionate intervention?

It would appear that the Secretary of State has a lot of flexibility to determine the extent of the intervention. Whilst it is appreciated that it is the intention that the power to intervene is deliberately broad so that it can be applied in a wide range of circumstances, there is an argument that the power is too dominant and this will increase the risk of a legal challenge from an authority subject to an intervention.

The Secretary of State should consider developing a comprehensive guidance document. Such a document would need to be far more extensive than the small number of examples given in the consultation document. The document can make clear that it is not an exhaustive list, but would give some comfort to authorities that interventions will only be considered when there is a specific and fundamental issue that needs to be resolved.

There are potential issues with the proposed interventions, which may result in the authority being required to implement a completely different investment strategy or for its investment function to be assumed by the Secretary of State or another body. If it can be demonstrated that this has resulted in an adverse impact compared with an authority's existing investment arrangements, then it could be argued that the authority should not be responsible for the costs of this.

The consultation document states that all costs of the intervention, which presumably includes an adverse impact on the value of the pension fund, will be met by the pension fund's assets. If the Secretary of State's intervention has an overall adverse impact on a pension fund's assets, then the department should be responsible for this, and not the pension fund.

Q8: Do the proposals meet the objective of the policy, which are to allow the Secretary of State to make a proportionate intervention in the investment function of an administering authority if it has not had regard to best practice, guidance or regulation?

The proposed changes to the LGPS Investment Regulations are welcome and will provide LGPS funds with the flexibility to implement their chosen investment strategies and will facilitate meeting the requirement to pool assets.

It is also appreciated that the Secretary of State requires a means to prevent an adverse impact from the proposed deregulation, and to ensure that all funds participate in the requirement to pool assets.

However, the circumstances under which this power of intervention would be used need to be further refined to ensure that it is only being used when an authority materially departs from best practice, guidance or regulation and cannot justify this action.

In addition, the proposed power to intervene appears to relate only to the investment function of an individual administering authority. The Secretary of State should clarify that this is the case and that the power of intervention would not be extended to the operation of the national asset pools.