Surrey Pension Team

Providing our customers with a better tomorrow

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Dear Sir or Madam,

Local Government Pension Scheme: Next steps on investments

Surrey County Council (Surrey) welcomes the opportunity to respond to this consultation on the supplementary issues and draft regulations in relation to the 'Local Government Pension Scheme (LGPS): Next steps on investments.

Surrey is the Administering Authority for the Surrey Pension Fund (the Surrey Fund) as part of the LGPS. The Fund has assets of more than £5 billion and has over 300 employers.

We welcome this consultation on the future of the LGPS and believe it is an important contribution to how we can collectively build on some of the good practice that has evolved across the LGPS since 2016.

In 2018, the Surrey Fund's jointly owned pooling company, Border to Coast began managing investments on behalf of 11 Partner Funds. The Partner Funds came together with an agreed set of principles that continue to guide how we work together. As a partner Fund of Border to Coast we are delivering against Central Government's original pooling policy objectives:

- Over £40bn pooled through Border to Coast, with clear plans to increase this in the years to come;

- £65m of net cost savings had been delivered to 31 March 2023, with expectations to increase this to £340m by 2030 (for the Surrey Fund, the cumulative savings net of setup, operating and transition costs at 31 March 2022 were £0.5m - with an expectation to increase this to £35m by 2030) and;
- Border to Coast's private markets team have given the Surrey Pension Fund's greater scope to explore this asset class and provided an extra layer of due diligence.

14 Border to Coast adds significant value to the Surrey Fund above and beyond the original pooling objectives as a centre of expertise. The Surrey Fund works collectively with Border to Coast partner funds in developing innovative and effective investment propositions – such as 'Climate Opportunities', which is delivering investment to drive the transition to Net Zero. The collective scale also increases our influence as an active steward – whether on executive pay, climate change, or on driving standards in Responsible Investment and ESG disclosure.

The Surrey Fund has made significant strides since 2018, with nearly all our listed assets now pooled and plans established for pooling any residual non-pooled assets. In addition, our private market allocations are now delivered through Border to Coast and we already have a strategic allocation of 20% of the total portfolio to this asset class.

That said, while significant progress has been made, evolution is not fixed. We recognise the need to review and adapt to reflect both our individual development and to meet the various dynamic challenges that may impact us in pursuit of paying pensions in an affordable and sustainable manner. While we do not oppose further consolidation in the LGPS, it should be consistent with the specific circumstances of Funds and pools with differing profiles and we would guard against an imposed solution that does not recognise this. Any evolution should be consistent with the guiding principle that it is the responsibility of the Surrey Fund to agree an investment strategy consistent with our fiduciary obligation to meet the pension promise of our scheme members, while ensuring that contributions for scheme employers remain stable and affordable.

We would note that it is regrettable, given the importance of governance to the successful delivery of the Government's policy intent in this consultation that there has been no comprehensive response to the Scheme Advisory Board's statutory recommendations in relation to the Good Governance Project, as we feel that significant progress in this area will assist in driving progress on the agenda reflected in this consultation.

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?

We recognise that 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 the increasing regulatory and governance complexity and burden on individual Funds.

This challenge can be addressed through:

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- 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 and support to develop, and manage the oversight of their investment strategies.
- 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% p.a.) – as can be evidenced via asset owners with "good governance" (this relates primarily to clear delegation of investment decision-making with strong oversight and scrutiny by the asset owner board) based on research[1] over the last 20 years. We recognise that standards are variable with smaller funds, in particular, less likely to rate themselves as highly on a number of important measures of quality. While each fund and pool should consider their own governance frameworks, progress on the 'Good Governance' review will support all of the LGPS and progress would therefore be welcomed by all.

Scale can deliver significant benefits. A 2022 publication[2] 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.

[1] Pension Policy Institute: "Defined Benefits: the role of governance"

[2] A Case For Scale February 2022

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.

There has been greater progress in pooling where Funds have worked constructively with their advisors and consultants to make pooling a success. In this situation the benefits that come from pooling (in both investment outcomes and reduced ongoing governance / advisory costs) are taken into account as part of the overall business case.

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
14 **2025?**

We support the principle of transferring, or having a clear path to transition, assets to pools. We believe that each funds' ISS should include a transition plan for assets to be transferred to the pools, as well as the composition and justification of any assets remaining outside the pool.

We would welcome clarity on the position of legacy illiquid assets particularly those in private markets. With fees already negotiated, and with typically no ability to adjust them post commitment, transferring these assets to the pool may simply incur new legal and tax costs. Apart from the existing 5% of assets which can be invested outside the pool, which is of a local and specific nature and due to its scale be ineffectively delivered through the pool, it may be appropriate to agree that individual Partner Funds should not seek to make new illiquid investments outside their pool from this date, and the pools (where appropriate) support Partner Funds on the oversight of legacy illiquid assets as they run-off. This could be on a case-by-case basis – for example it is possible to transition UK Real Estate assets with appropriate tax planning and achieve strong investment and business case benefits.

We would also welcome clarity on 'passive' investments. In our current arrangements, we have jointly procured 'market index' funds in large, liquid and low-cost pools. These assets benefit from oversight from Border to Coast, and there is no obvious value for them to be replicated within the Pool. We believe that these investments should continue to be considered pooled ("assets under pool management"). We also note the current guidance that up to 5% of assets can be invested outside the pool. We believe this flexibility should remain – particularly when it is supporting other relevant objectives, such as making local investments.

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 is reflective on the manner in which we have sought to pool. Nonetheless, we would urge caution on being overly prescriptive in describing any model in guidance as doing so would bring with it the risk of stifling 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 could potentially play a significant role in supporting the development of, and being responsible for implementing, a Partner Fund's investment strategy. 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.

When drafting guidance, due consideration should be given to investment strategies that meet needs of a diverse employer group. This could include employers with differing maturity characteristics that may benefit from different investment approaches to protect their position. Sufficient specific investments would need to be available to adopt these.

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 system 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. 14

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 this is being executed. To be effective in this role Committees will need to have in place appropriate delegation of functions which are not central to the setting of strategy to Officers, who have sufficient experience and knowledge to support the Committee. In turn, Officers (and Committee's) can be supported by the centre of investment expertise that resides in the pool that they own, which is also responsible for the implementation and management of that Funds investment strategy.

The knowledge and understanding of Pensions Committees may be supported by independent advisors but cannot be a replacement – and may play a key role in supporting the Committee in their responsibilities in the oversight and scrutiny of the investment strategy by the pool.

For Pension Committees, a key component to this is an effective training policy, which is reported against as part of clear delegation of functions between Committee and Officers. This is something the Surrey 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 condition on sitting on a Pension Committee should match that of membership of a Local Pension Board.

Given both the significant training requirements, and the responsibilities of membership of a Pension Committee, we believe it is appropriate that Pension Committee members should be appropriately remunerated.

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 Scheme Advisory Board 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 is progressed as part of the Good Governance project. We would also welcome a complete review of the regulations to simplify and streamline processes.

While support reporting net savings, this needs greater consideration – specifically "against what?". In calculating our savings, we are comparing our current position with (often) data from 2015/16 – which is not necessarily the market pricing we see today. There is a danger that this information becomes dated and irrelevant. Equally, a focus on cost may also drive unintended consequences (particularly given the desire from the Government to increase investment in more expensive asset classes, such as private markets). 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, although two funds may superficially have similar investment strategies, they may be seeking to deliver significantly different outcomes. There is a danger that returns are taken out of context – and could lead to inappropriate short term investment decisions being made.

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

We support clear and consistent reporting by the Scheme Advisory Board, 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 Scheme Advisory Board.

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

Although we do not disagree with the definition outlined in the consultation, it should be stressed that levelling up investments should be consistent with the investment strategies of Funds. Through Border to Coast a new private markets strategy, ‘UK Opportunities’ is being developed. Set to launch in April 2024, we believe this will provide the Surrey Fund 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 unable to be effectively delivered through the pool. As such, this exemption to making these investments outside of the pool should be maintained (although this should still be subject to regulatory permissions, resourcing, recognising the importance of managing conflicts of interest that may still arise, and the role pools can play in advising in relation to non-pooled investments).

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, it needs to be recognised that there are several implications that need to be fully considered and risks mitigated. These include issues such as:

- Proposition development – currently the Border to Coast propositions are designed with, and for, 11 Partner Funds who are both shareholders and customers. Care will be required should an external pool customer(s) wish to evolve existing propositions. The existing governance structures and processes will need to be reviewed to overcome this challenge.
- Niche strategies – certain investments may have capacity issues. For example, despite significant demand, the initial Climate Opportunities strategy at Border to Coast was capped at £1.35bn. Care will be required in balancing the needs of shareholder customers vs external pool customers for capacity constrained investments. 14
- Cost model – as shareholders, existing customers principally manage risk through Border to Coast's regulatory capital. As non-shareholders, external pool customers would be subject to different pricing.
- Managing demand – 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 and, in accepting external customers, there is a risk of managing in- and out-flows, potentially destabilising our ability to plan the required capacity in various functions of the business. There are also similar considerations regarding management of liquidity in certain propositions.

Management of additional customers will require careful consideration, particularly noting the potential additional layer of due diligence costs that will 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, rather 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 the Surrey Fund is to generate the appropriate risk adjusted returns to ensure we can operate the LGPS in an affordable and sustainable manner. Where ancillary objectives can be co-delivered without impacting these returns or increasing risk, such as those outlined in the Levelling Up White Paper, this is to be welcomed. We believe that 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.

It is for this reason that the Surrey Fund is supportive of the launch of the Border to Coast 'UK Opportunities Fund', which is designed to deliver such investment across the regions of the UK. 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 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 ISS.

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?
14 **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 DB pension schemes, it is essential that we adopt appropriate diverse investment strategies designed to balance risk and return to ensure the LGPS remains affordable with stable employer contributions.

As part of this approach, private markets can play an important role. The creation of Border to Coast has significantly enhanced the Surrey Pension Fund's ability to access this asset class. As part of our investment strategy, our allocation to private markets already currently stands at 20%.

We note the reference to private equity. It is our belief that this is a relatively narrow definition. Indeed, early-stage growth, especially that focused on tech, is relatively high risk. For investors who have not made meaningful or any previous commitments to private capital more broadly, this is a challenging entry point and risks disappointing or volatile returns/losses which could discourage future investment in private markets.

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

Over the medium term we believe we will meet the aspiration to invest 10% of our assets in these areas. 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/or the necessary policy certainty to protect these potential investors. Examples include policy certainty on renewable energy, transport and other 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 (perhaps with the support of BBB or UKIB) that enable risk sharing or return visibility.

While there is understandably a continued focus on costs, we recognise that private markets are a more complex and expensive asset class. Through Border to Coast, the Surrey Fund has access to the capability and capacity to access these markets in an effective and efficient manner; in the last Border to Coast annual report they highlighted a c.24% reduction in fees in this key asset class across partner funds.

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 British Business Bank (BBB) and the UK Infrastructure Bank (UKIB) being 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 source and commit to ventures that meet their normal investment criteria.

We do note that one of the key objectives of LGPS pooling was to reduce the fee burden paid by pension funds, and in a private market context, reduce the reliance on fund of fund structures which introduce an additional layer of fees and carry (profit share) expense. As
such, any vehicle should be offered on a cost only basis if the intention is to encourage 14
greater participation in this part of the market. Additional fee load will detract potential investors who are sensitive to fees. BBB will be investing balance sheet capital into all investments so a successful investment policy will deliver profitability for them without a reliance on fee income.

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

The Surrey 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?

No comment.

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,

Leigh Whitehouse
Deputy Chief Executive