Response to Local Government Pension Scheme;
Investment in Partnerships
December 2012

Local Authority Pension Fund Forum

Response to Department of Communities and Local Government (DCLG) Investment in Partnerships consultation

The Local Authority Pension Fund Forum was set up in 1991 and is a voluntary association of 55 local authority pension funds based in the UK with combined assets of approximately £115 billion. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest. The Forum has taken the opportunity below to provide our view on those issues which we consider relevant to our activities.

1 Introduction

This report considers the DCLG consultation paper LGPS: Investment in Partnerships and outlines a response. This is followed by a general background note for information on the current position on infrastructure investing by pension funds so that the DCLG consultation can be seen in context.

2 DCLG Consultation

2.1 The attached consultation paper was issued by DCLG at the beginning of November 2012 with responses required by 18 December 2012 and concerns amendments to the LGPS Investment Regulations in order to help facilitate funds invest in infrastructure projects. The consultation is clear in not recommending infrastructure investing, but is facilitating a framework in which "local fund managers have appropriate levels of flexibility to maximise their investment opportunities ".

2.2 A number of funds and interested parties have highlighted that infrastructure investing is usually achieved by the use of limited partnerships which is subject to a limit in the regulations. Limited partnerships are also used for other types of investment such as private equity leading to a position whereby some funds have no or limited capacity to invest in new limited partnerships because of past commitments. The current limit specified in the Investment Regulations is 15% and the consultation paper proposes an option of increasing this to 30%. A further option of creating a specific control limit for infrastructure is also presented, presumably on the basis that other control limits in the regulations would not apply e.g. amount invested in limited partnerships. The current investment regulations are generally outdated and do not work well with the present investment opportunities pension funds seek to use producing a level uncertainty on interpretation in some areas. There are not the same problems for private sector pension funds as they are governed by a different set of regulations which whilst broadly achieving the same objectives, are constructed to operate in the current environment and have better clarity.

2.3 The consultation requests a response to five questions which are set out below together with a potential response:

Question 1: How best could the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 be amended to enable local authority pension funds to invest more easily in infrastructure vehicles?

Response: The proposed increase to 30% in the limit on investments in limited partnerships is supported and the additional flexibility it brings welcomed. However this matter highlights the broader point that the LGPS Investment Regulations need a fundamental review as they originated when investment opportunities were much more limited and investment vehicles simpler and less in number. Practitioners and interested professional bodies have been united in supporting a major overall with a view that the LGPS could adopt the private sector pension fund investment regulations which are working well with adequate safeguards. A commitment to undertake a fundamental review of the LGPS Regulations would be welcome.

Question 2: What would be the most appropriate limit on investments in partnerships contained within the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009?

Response: Comments included in response to question 1. Accepting the current issues with the investment regulations, an increase to 30% would facilitate the capacity for significant infrastructure investment, but not distort the current regulatory framework.

Q3: Should a new investment class for investment in infrastructure (including via partnerships or limited liability partnerships) be created and be inserted into the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009? If so, what would be an appropriate limit for such a class? How might this be best defined in regulation?

Response: A new investment class for infrastructure is not supported. It would continue to add complexity to a set of regulations that are already outdated and open to interpretation in a number of areas. Problems can be envisaged in defining infrastructure investment and what is included. Any definition would need to be clear on what is being covered in order to avoid problems over interpretation. A key issue would be to decide if the vehicle for the investment is a feature as well as the nature of the investment no matter how the investment is made. For example would a definition include all vehicles for investing such as limited partnerships, pooled arrangements, private and quoted equity, bonds etc? This would potentially be affected by other controls in the regulations e.g. limited partnerships and pooled vehicles. Some investments may have to be apportioned where they do part infrastructure and part other activities. A definition that is based upon the nature of the underlying activity presents other problems of what would be included, for example would housing association openly traded bonds, FTSE quoted building companies, proportions of indexed funds be included?

Question 4: Are there other ways, not specifically raised in this consultation document, that the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 could be amended to increase flexibility for local authority pension funds to invest in infrastructure projects?

Response: Raising the limited partnership limit to 30% removes the current problem for a number of funds and on its own would enable all funds that determine an infrastructure investment opportunity is appropriate for their fund to proceed, but other problems could emerge later due to the outdated nature of the current regulations. A comprehensive review of the current regulations would be helpful. Also LAPFF, with a number of the larger LGPS Funds, sponsored a study by the Smith Institute into investing in growth (referred to in paragraph 8 in the consultation document). This identified a number of actions that could be taken which would help facilitate infrastructure investing. These involve some actions by DCLG and are attached as Appendix A.

Question 5: Are there ways in which the Regulations could be amended to facilitate investment in infrastructure specifically in the United Kingdom, where local funds believe that appropriate rates of return can be achieved?

Response: Covered in response to question 4.

3 Background to Infrastructure Investing

3.1 Definition of Infrastructure.

3.1.1 Infrastructure can be defined in a number of ways but is usually regarded as investing in projects to develop or upgrade physical assets to generate income and thereby return for investors. The areas of activity covered include transport, communications, health/education and utilities. Some would broaden the definition to include other aspects of property investing such as development of or operation of residential, retail, offices and industrial units. This links to local regeneration projects being included in the definition of infrastructure.

3.1.2 Infrastructure investment is usually considered to have two elements, the development of the infrastructure and its subsequent operation. The greater risk usually lies in the development and it therefore carries the higher return. The two elements can be separated into separate investments with the developer seeking to exit after the development and leave the operation to an organisation with a different set of skills and risk /return expectations.

3.1.3 The key features of infrastructure investments are their long term nature, predictable revenue, highly illiquid nature, lower exposure to the economic cycle, and potential inflation hedge matching growth in pension fund liabilities. Individual projects tend to be large and apart for a few funds, are beyond the capacity of an individual fund. Pension funds therefore seek to invest with others so that an exposure to a number of projects can be achieved and the risks reduced. Investments can be made directly by financing a project or indirectly by acquiring an interest in a company or units in a fund.

3.2 Investments by Pension Funds

3.2.1 A number of funds have exposure to infrastructure already through a wide range of investments e.g. direct into infrastructure funds both UK and overseas, equity and bond holdings in building companies and infrastructure operators, direct property. Due to the various options for defining infrastructure, there is no information available on the amount pension funds have invested. Some may have an allocation of 2% to 3% to infrastructure and separately 5% to 8% to property excluding quoted equities and bonds. There will be significant variations around these figures amongst LGPS funds.

3.2.2 Infrastructure investments can vary significantly amongst public and private sector funds in terms of scale and nature of their exposure e.g. funds can have interests in limited partnerships who seek to invest in a number of infrastructure projects, a property interest directly or through a pooled vehicle, in a shopping centre an element of which is seen locally as a key regeneration/infrastructure issue and at the other end of the scale a very large pension fund could hold a controlling interest in a regional airport.

3.3 Opportunities for investing and expectation on pension funds

3.3.1 The infrastructure market is well developed overseas where the charging for public infrastructure assets is more common e.g. toll roads. Some funds are known to have significant exposure to investments in infrastructure as a separate asset class in their investment strategy, particularly the larger public and private sector funds.

3.3.2. The interest in pension fund monies for financing infrastructure has intensified in recent years with the lack of available other financing to support projects. The use of pension fund assets has been seen as a source of infrastructure investment by government, professional bodies, local authorities for regeneration purposes, managers/owners of assets.

An indication of the interest can be highlighted with the Government's comments in its paper in November 2010 Blue Print for Technology, the Memorandum of Understanding between HM Treasury and NAPF and Pension Protection Fund, the Kay review into UK Equity Markets and Long Term Decision Making, the Future Homes Commission report 'Building The Homes and Communities Britain needs'. LAPFF commissioned its own report on impact investing by the Smith institute which was published recently and has been referred to earlier.

3.3.3 A press statement issued with the launch of the DCLG consultation further illustrates the point of pension funds being seen as a source of financing a broad range of infrastructure projects:

Councils would be free to pump as much as £22 billon more of pension fund investments into infrastructure supporting the Government's ambitions to build more homes, roads or high speed railway under proposals announced by Local Government Secretary Eric Pickles today.

The proposals would potentially allow councils to double the amount they can legally invest from their pension funds directly into key infrastructure projects in a new and more efficient way that ensures long-term value for the taxpayer.

Investment in infrastructure is a vital part of the Government's economic growth strategy. Innovative approaches that increase the amount of finance available for projects are needed to back ambitions for the economy and to help manage the inherited deficit.

The Local Government Pension Scheme England and Wales is administered by 89 separate local funds that hold combined investment assets worth £150 billion.

Pension fund rules are there to make sure investment risks are spread across different types of investments to give taxpayers long-term protection. Fund managers are currently limited in the amount they can invest via partnership arrangements, which includes many types of infrastructure investment.

The proposals published for consultation today include an option to increase the current limit of 15 per cent to 30 per cent. This would clear the barriers standing in the way of better council investment giving them the scope to inject up to £45 billion in such arrangements.

Eric Pickles said:

"Unlocking Town Hall pension pots, so they can be used to invest in vital infrastructure projects, is a common sense decision that will help this country complete on a global scale and get Britain building.

"By lifting the restrictions controlling local pension investments councils could pump a further £22 billion directly into job creating infrastructure projects that will boost our economy.

"This is potentially a huge development and investment opportunity we simply cannot afford to ignore that also allows us to maintain long-term value for money for the taxpayer."

A recent report by the Future Homes Commission said council pension funds could be used to build key infrastructure projects like new homes in the UK without increasing the government deficit.

Investment decisions remain for individual local pension funds, which have a duty to protect the local council taxpayers, and local services and to ensure that there are no conflicts of interest.

3.3.4 A change to the LGPS Investment Regulation would help facilitate infrastructure investing, but pension funds would still have significant due diligence to undertake ensuring any investment is in accordance with their investment strategy, the investment produces an acceptable risk/return, has appropriate scale (direct, pooled or shared) and adequate diversification is achieved in terms of exposure to the number of projects and type of projects. Funds would depend on appropriate expert advice and need experienced mangers/operators.

APPENDIX A
Local Authority Pension Funds: Investing For Growth – Conclusions.

Conclusions and recommendations
The following section draws together some common themes across the call for evidence, interviews and workshops, and makes practical recommendations for action.

Our research suggests a lack of clarity on the asset class for impact investment and a need to scale up knowledge of trustees about impact investments. A perception of suboptimal returns from impact investment remains among some funds; however, most stated an interest in these opportunities but “only if it stacks up financially”, or if this area can be demonstrated as a credible asset class by “addressing the issue of fiduciary responsibility”. The research also suggests a need for co-investment (local authority pension fund and external fund managers) to eliminate the danger of perceived conflicts of interest, as well as investing at scale through external fund managers with a track record in impact investments – rather than making direct impact investments. The other critical factor will be to promote how fiduciary responsibility is/can be delivered operationally when making impact investments.

Our first recommendation relates to providing a better mechanism for developing information and knowledge, in effect taking this research work forward.

Recommendation 1: Better information and clearer guidance
Local authority pension funds should work with the Local Authority Pension Fund Forum (LAPFF), relevant government departments, external investment fund managers, and the Chartered Institute of Public Finance & Accountancy to develop guidance and technical papers on impact investment and pooled investment vehicles. The guidance documents should be linked to evaluation and lessons learned from progress towards delivering the first recommendation. Consideration should be made to including these outputs within the Statement of Investment Priorities guidance and promoting their use via online knowledge and skills development platforms.

Our second recommendation relates to the continued development of the skills and knowledge of local authority pension fund trustees and pension fund officers, and the important role of investment intermediaries in helping to develop impact investment.

While the research did highlight some minor skill shortages, these were typically addressed through the continuous programme of training provided for trustees as required by the Myners review. However, the research highlighted a need for greater input from investment intermediaries to support the scaling up of impact investment through the advice they give to institutional investors. This would also support the emergence of impact investment as an asset class in its own right.

Recommendation 2: Demonstrable case studies and training on matching impact investment within fiduciary duties
LAPFF should work with investment intermediaries and consultants to develop good practice case studies for promotional use by “champion trustees” on how impact and

infrastructure investments can be used effectively within their fiduciary duties to enhance the risk/reward profiles. LAPFF should explore member support and funding for the development of a series of training seminars for pension fund officers that highlight emerging finance vehicles which “layer” investments, combining high- and lower-risk investments (for example, including property assets to underwrite risk). While advisers and fund managers need to be given more freedom and a greater mandate to consider impact investments, there also need to be higher levels of understanding in the funds they support.

Our third recommendation relates to requests from pension funds for greater flexibilities in how funds are managed in terms of the limits set out in statutory legislation; in particular, in relation to the limits set for investment in partnership vehicles, enabling the recommendations set out in this report to be taken forward.

Recommendation 3: Legislative adjustments – enhancing potential for flexibility
The government should review and explore potential changes to restrictions on investments (as set out in the *Local Government Pension Scheme Schedule – Management & Investment of Funds*), to enable local authorities to have sufficient flexibility to address the issues and recommendations set out in this report, in particular those relating to limits for investment in limited partnerships.

There were frequent requests for greater input and support from government throughout the research, ranging from information and guidance to a more proactive stance whereby government would underwrite some of the risk in impact investments. Given the current curb on public spending it is not clear that this would be forthcoming, especially with the current levels of debt on the government’s balance sheet. The next two recommendations give practical steps which the government could make, along with relevant agencies, to support impact investment.

Recommendation 4: Create an enabling platform – a clearing house
Local authority pension funds and other relevant partners, including LAPFF, should lobby government to fund an independent external agency to act as a clearing house, gathering data from a wide range of (impact) projects around the UK, supporting transparent valuation and consistent financial reporting standards of impact/infrastructure projects. The agency would support the development of a combined national framework and standard for assessing economic, social and environmental value that would be of interest to the public, politicians, commissioners, social investors and local communities.

Recommendation 5: A new pooled vehicle
The potential should be explored for a “core group” of larger pension funds to contribute funding for the commissioning of an independent manager to help determine and deliver a way forward for pooled impact investment funds. The aim of the fund manager would be to develop a joint investment agreement that would see a group of five or more signatories each putting £5 million to £10 million into a pooled vehicle, with a view to inviting local authorities/public-sector bodies to put forward bids for the investment, including the leverage of other sources of public and private investment

