NAPF

Securing the future of pensions

Local Government Pension Scheme – Investment in Partnerships: a response by the National Association of Pension Funds

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Executive Summary

The NAPF welcomes the opportunity to respond to this consultation. On behalf of our Local Authority members we have been arguing for changes to the Local Government Pension Scheme (LGPS) Investment Regulations for a number of years. In particular, we welcome the new Local Government Minister's swift action on the specific issue of the cap on Limited Partnerships which is preventing some Local Authorities from investing in alternative investment sources, such as infrastructure.

It has long been recognised, by NAPF and others, that the LGPS Investment Regulations are prescriptive, out of date and do not meet the needs of Local Authority Pension Funds to enable them to effectively manage their investment risks and best meet the needs of scheme beneficiaries. In particular these regulations are currently preventing some schemes investing in diverse asset classes such as infrastructure.

The Government is looking to institutional investors such as pension funds to invest in infrastructure as part of its National Infrastructure Plan. NAPF believes that infrastructure investment can provide an appropriate investment for pension funds and we have been working with the PPF to develop the Pensions Infrastructure Platform, a vehicle that will provide pension funds with the long-dated, stable, indexed linked cash flow investment they require.

However, a number of our Local Authority members have told us that they are very close to the 15% limit on Limited Partnerships, which they say is preventing them investing in infrastructure, including through the Pensions Infrastructure Platform.

Therefore we recommend that the Government proceed swiftly with option (a) in the consultation, to **'Increase the limit on investments in partnerships from 15% of a local authority pension fund to 30%'**. NAPF's Local Authority members believe this is the only way to give funds the immediate flexibility they require to diversify their assets in these difficult economic times.

However, whilst NAPF believes that option (a) is the best solution for the immediate issue of enabling infrastructure investment where this is in pension schemes' best interests, it does not solve the wider problem of the overly prescriptive nature of the LGPS investment regulations.

NAPF would like to see Government take forward wider reform of the Regulations - to make them more principles-based and bring them into line with the regulations that cover private sector pension fund investments. This should be taken forward as soon as possible to ensure that Local Authority Pension Funds have the flexibility they require to tailor their investments in response to an ever changing investment landscape and, ultimately, deliver good outcomes for their members and value to the taxpayer.

About the NAPF

The National Association of Pension Funds is the leading voice of workplace pension provision in the UK. We represent 1,300 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. We represent both public and private sector schemes, including 81% of the local authority pension funds. Our members provide pensions for 16m people and collectively hold assets of around £900bn. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

Introduction

The NAPF welcomes the opportunity to respond to this consultation by the Department for Communities and Local Government. On behalf of our Local Authority members we have been arguing for changes to the Local Government Pension Scheme (LGPS) Investment Regulations for a number of years. We welcome the new Local Government Minister's swift action on the specific issue of the cap on Limited Partnerships which is preventing some Local Authorities from investing in alternative investment sources, such as infrastructure. Both Government and pension fund objectives align well when it comes to infrastructure. Government is looking to pension funds to invest more in infrastructure and contribute to the National Infrastructure Plan. Pension funds are looking for alternative sources of long-dated, stable, indexed linked cash flows which new forms of infrastructure investment, such as the Pensions Infrastructure Platform will provide.

In developing our response to this consultation NAPF included specific questions on LGPS investment in this year's NAPF Annual Fund Member Survey. Discussions were also held with our Local Authority Steering Group and at our Local Authority Forum in November (attended by over 40 Local Authority Pension Funds).

The case for reform

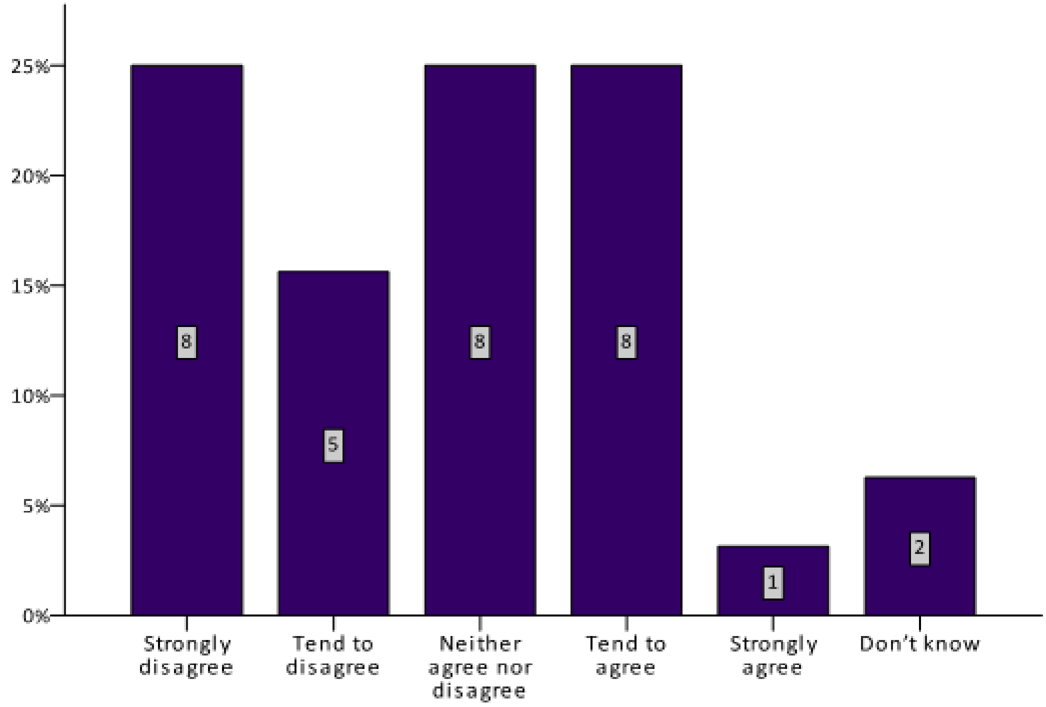
With over £900bn invested in NAPF member pension funds, how those funds are invested will make a critical difference not only to viability of scheme funding but also to the UK economy. NAPF takes an active interest in all aspects of pension fund investment policy. We work with Government and regulators to ensure a viable, well regulated and cost-effective investment environment exists for trustees and sponsoring employers.

It has long been recognised, by NAPF and others, that the LGPS Investment Regulations are overly prescriptive and out of date. They do not meet the needs of Local Authority Pension Funds in enabling them to effectively manage their investment risks and meet their long term funding objectives – to meet the needs of their beneficiaries and provide value to the taxpayer.

The issue is simple. In contrast to private sector occupational pension schemes, the LGPS investment regulations prescribe arbitrary limits on the amount Local Authority funds can invest in certain types of legal structures, for example Limited Partnerships or collective investment schemes, potentially leading to sub-optimal investment allocations for LA pension funds. The reference to the underlying legal structure is arbitrary and does not necessarily correspond to the underlying risk of the investments. This is compounded by the fact that the regulations have also failed to keep up with changes in the investment world making it difficult for funds to make appropriate investment choices. That is why NAPF, along with CIPFA and others have long campaigned for the LGPS investment regulations to be reformed, to reflect the principles-based approach used in the private sector.

Local Authority schemes want change. In this year's NAPF Annual Survey, less than one third of Local Authority respondents thought the investment regulations were a useful way to manage investment risk. In addition some of the biggest local authorities, those most likely to invest in infrastructure, are now close to the 15% limit (or have reached it) and have told us that the regulations have prevented them from investing in specific funds over the last year.

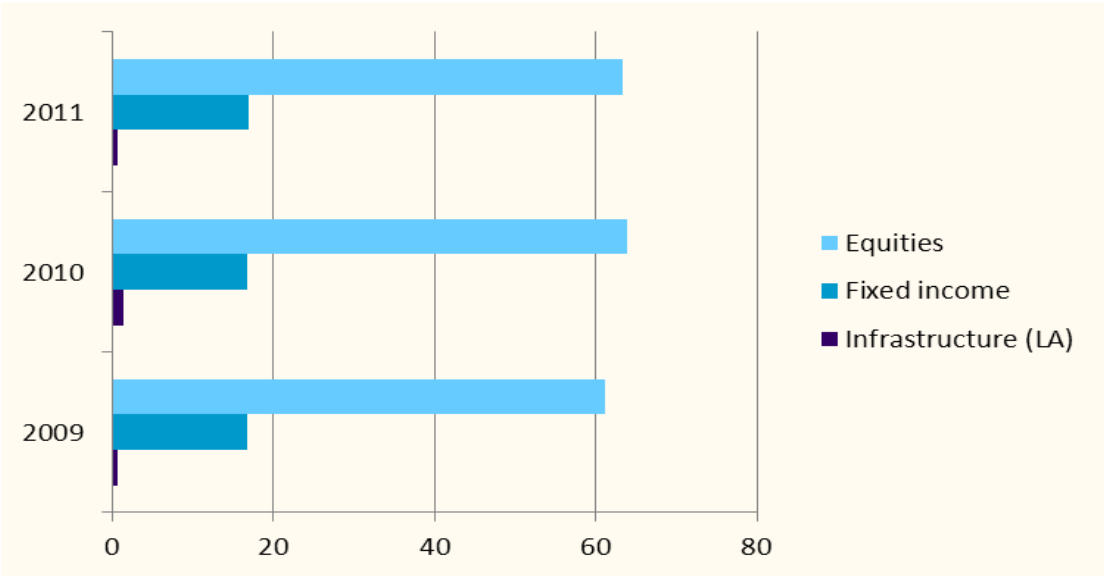
I find the LGPS Investment Regulations helpful when managing risk



Pension funds and infrastructure

This inability to invest in appropriate assets conflicts with the wider Government growth agenda which is focused largely on encouraging long term private sector investment in public infrastructure projects. The Government's National Infrastructure Plan states that the UK needs over £200bn of new infrastructure investment over the next five years - the vast majority of which will need to be provided by the private sector. The Government is looking to institutional investors, such as pension funds to provide that investment. However, infrastructure investment by UK pension funds is currently low compared with overseas pension funds. UK pension funds hold over a trillion pounds in assets, but only around 2% of that is invested in infrastructure. In Canada the aggregate assets invested by pension funds in infrastructure is C$35bn (£22bn) – nearly 4% of total managed assets and in some individual Canadian funds that amount is much higher.

Infrastructure and other asset classes (Local Authorities)



There are a number of reasons why this is the case: UK pension schemes operate on a smaller scale – our largest fund is £32bn and the regulatory and accounting environment pushes pension funds away from equities into fixed interest investments. However infrastructure should be a good match for pension schemes, it provides a tangible investment and can support sustainable and socially responsible investment. It can also provide low-risk, long term investment opportunities with returns that are inflation-linked. This is especially useful in the current economic environment where low gilt yields mean that pension funds are looking for alternative sources of long-dated, stable, indexed linked cash flows.

Another reason why UK pension funds do not currently invest in infrastructure is that traditional offerings have been characterised by pension funds having to pay too much for a fund that is not well aligned with what they want to achieve. For example, fund manager fees have been high and the investments have been highly-leveraged with no inflation-linking. In addition, pension funds often lack the in-house expertise to invest in such a complex asset. NAPF has been told by our LGPS members that they want to invest more in infrastructure, but to do so the terms need to be right and give pension funds what they want.

In response to the lack of opportunities for pension funds to access infrastructure as an asset class, NAPF and PPF have been developing the Pensions Infrastructure Platform (PIP). The PIP is designed for pension funds, by pension funds. It will benefit from pension funds operating on a mutual basis, providing access to infrastructure on the terms pension funds want – secure, long dated, index-linked cashflows (RPI+2-5%) at low cost and with low leverage. There are now 8 funds signed up to the platform, including West Midlands Pension Fund & Strathclyde Pension Fund. The PIP is planned to launch in the first half of next year.

However, a number of our Local Authority members have told us that they are very close to the 15% limit on Limited Partnerships, which they say is preventing them investing in infrastructure, including through the Pensions Infrastructure Platform. The purpose of these limits is to ensure that schemes diversify and use a range of investments, but clearly in this case the limits are having the opposite effect in preventing schemes accessing an investment class that is well-suited to their needs and could help them diversify further.

This is why the NAPF welcomes CLG's consultation on this specific issue. The Government needs to act, and act quickly to ensure that pensions schemes who are currently unable to invest in infrastructure can do so and contribute to the Government's aim of generating growth. The most efficient way to do this would be by increasing the limit on investments in partnerships from 15% of a local authority pension fund to 30%.

Consultation questions

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?

The consultation puts forward two options:

(a) Increase the limit on investments in partnerships from 15% of a local authority pension fund to 30%; or

(b) Create a new investment class for investment in infrastructure (including via limited liability partnerships), with an appropriate investment limit of 15% of an overall fund.

Our members with an interest in Local Authority pensions are unanimous in their support of option (a) and believe this is the only way to give funds the immediate flexibility they require to diversify their assets in these difficult economic times. Increasing the limit on investments in partnerships could be done quickly and with minimal upheaval and ensure that those Local Authority

Pensions Funds who are currently unable to invest in infrastructure can do so in a timely manner that contributes to the Government's aim of getting more investment in infrastructure.

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?

Placing a notional limit on investment types is one of the wider issues our members have with investment regulations as currently written. As one of our members expressed in their response "Exposure limits expressed in terms of certain investment vehicles are meaningless in determining risk." However in the short term Local Authorities are coming up against the current 15% barrier and the NAPF believes that increasing the limit to 30% would allow funds greater flexibility.

Question 3: 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?

We believe that a new investment class for infrastructure will present LGPS funds with some serious practical difficulties. It would be unworkable for the following reasons:

(i) it would catch not only direct investment in infrastructure, and investment in infrastructure funds, but any equities and bonds in companies that could be categorised as the infrastructure industry;

(ii) the fund managers of these equity and bond portfolios will usually have discretionary mandates and monitoring the exposure to infrastructure across all the different managers would be near impossible;

(iii) there is no clear definition of infrastructure and developing, maintaining and future proofing a definition in the context of an extremely innovative fund management industry who develop new approaches and products all the time would be exceedingly difficult; and

(iv) the investment guidelines of any infrastructure fund would need to align with the statutory definition of infrastructure, which is unlikely to be workable in practice.

Finally NAPF believe that option (b) is fundamentally inconsistent with the rest of the investment regulations. The existing definitions and restrictions are focused on the form of an investment not on an asset class or underlying economic exposure – they cover contracts, partnerships, securities, deposits, units, shares etc. "Infrastructure" does not sit properly within that framework. Para 3.1 of the consultation says "the Government is not proposing to fundamentally change the framework for investment provided by the Investment Regulations." Option (b) would do that. Ultimately we do not believe that a new investment class for infrastructure would lead to an increase in infrastructure investment.

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?

NAPF would like to see Government take forward wider reform of the Regulations - to make them more principles-based and bring them into line with the regulations that cover private sector pension fund investments. This would allow Local Authority Pension Funds to effectively manage their investments in a way that best suits meet their long term funding objectives – to meet the needs of their beneficiaries and provide value to the taxpayer, including investing in infrastructure where appropriate.

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?

The NAPF Autumn Statement submission called on Government to do more to help facilitate investment in infrastructure by long-term, low risk investors such as pensions funds. This would involve, for example, re-working the procurement process so as to award higher marks to a lower leveraged capital structure and ensuring that any forthcoming EU regulation does not further limit the capacity of pension funds to invest in infrastructure by classing it as a high risk asset simply because it is unlisted.

Conclusion

NAPF looks forward to a swift change to the limit on investment in Limited Partnerships so that appropriate pension fund investment is not hindered at this critical time. Part of this resolution will be ensuring that any changes made to the investment regulations governing England and Wales are replicated in Scotland as soon as possible.

However, whilst NAPF believes that option (a) is the best solution for the immediate issue of enabling infrastructure investment where this is in pension schemes' best interests, it does not solve the wider problem of the overly prescriptive nature of the LGPS investment regulations.

NAPF would like to see Government take forward wider reform of the Regulations - to make them more principles-based and bring them into line with the regulations that cover private sector pension fund investments – and to do so as soon as possible to ensure that Local Authority Pension Funds have the flexibility they require to tailor their investments in response to an ever changing market and, ultimately, deliver good outcomes for their members and value to the taxpayer.

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