JOHN RAISIN FINANCIAL SERVICES LIMITED

The Nottinghamshire Local Pension Board

The Local Government Pension Scheme Investment Regulations 2016

A paper by the Advisor to the Pension Board March 2017

Background

On 1 November 2016, ***The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016*** (the LGPS Investment Regulations 2016) came into force. This paper examines and explains the background to the Regulations, their contents and implications.

In November 2015, the Government had issued a Consultation proposing reform of the LGPS Investment Regulations. This Consultation proposed a number of significant changes including:

- Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (as Amended)

- Removing Schedule 1 to the 2009 Regulations which placed % based restrictions on the nature of investments LGPS Funds could make and replacing this with a *"prudential person"* approach similar to that which applies to private sector Defined Benefit Pension Schemes. Under the proposed revised approach, it would be a matter for each LGPS Fund to determine the mix and balance of its investments taking risk into account

- Further deregulation particularly in relation to the appointment and review of external Investment Managers

- The replacement of the existing requirement for each LGPS Fund to define its investment strategy in a Statement of Investment Principles (SIP) with a requirement to prepare and approve an Investment Strategy Statement (ISS)

- A requirement for each LGPS Fund to define its approach to Investment Pooling (part of draft Regulation 7)

- A proposed power for the Secretary of State (draft Regulation 8) to issue directions to an LGPS Fund in relation to investment matters where the Secretary of State had determined that the Fund had failed to have regard to the requirements of regulation and guidance

The Consultation also included a specific question seeking views on the use of derivatives. The extent to which/circumstances in which LGPS Funds could utilise derivatives had been unclear under the 2009 Investment Regulations.

Government response to the Consultation

In September 2016, the Government responded to the Consultation by issuing three documents. These were the 2016 Investment Regulations, Statutory Guidance to accompany the new Regulations and the formal response to the Consultation.

- ***The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2016*** which were laid before Parliament on 23 September 2016 and came into effect on 1 November 2016 were very closely based on the Draft Regulations issued in November 2015. These include the introduction of a *"prudential person"* approach to LGPS investment and also a clearly positive emphasis on both Environmental, Social and Governance (ESG), and Stewardship considerations. The Regulations confirm the Government's intention to proceed with Investment Pooling and the introduction of a power of intervention (Directions) by the Secretary of State in specified circumstances

- The Statutory Guidance entitled ***Local Government Pension Scheme Guidance on Preparing and Maintaining an Investment Strategy Statement*** provides guidance for LGPS Funds in preparing their Investment Strategy Statement in accordance with Regulation 7 of the 2016 Investment Regulations. Guidance is given in respect of each of the six component parts of Regulation 7. This Statutory Guidance also provides context and clarification in respect of the issuing of Directions by the Secretary of State to an individual LGPS Fund under Regulation 8 of the 2016 Investment Regulations. Based on the Guidance such a Direction would only be issued if a Fund was in clear breach of the Regulations or Statutory Guidance and after careful consultation including with the relevant Fund.

- The ***Government response to the Consultation*** of November 2015.

The LGPS Investment Regulations 2016

There are 12 individual Regulations in the LGPS Investment Regulations 2016. Significant changes as compared to the LGPS Investment Regulations 2009 (As Amended) relate to:

Definition of Investment

Regulation 3 of the 2016 Regulations provides a revised definition of *"investment."* Overall the definition of *"investment"* in the 2016 Regulations is less complex than that in the 2009 Regulations. The new Regulations remove the previous uncertainty around the use of derivative instruments. Unlike the 2009 Regulations the 2016 Regulations specifically list *"derivatives"* as a permissible investment.

Investment Strategy Statement (which includes Asset Allocation decisions, Investment Pooling, ESG and Stewardship considerations)

Regulation 7 of the 2016 Regulations introduces the requirement for each LGPS Fund to formulate an **Investment Strategy Statement (ISS).** This document replaces the Statement of Investment Principles (SIP) required under the 2009 Regulations.

As proposed in the November 2015 Consultation the limits in respect of % allocations to particular investments contained in Schedule 1 of the 2009 Investment Regulations are not carried forward to the 2016 Regulations. LGPS Funds now have the freedom to implement a *"prudential person"* approach to their Investment Strategy approach. They must however comply with Regulation 7 of the 2016 Investment Regulations and Guidance issued by the Secretary of State. Such Guidance was issued in September 2016 and may subsequently be revised.

Regulation 7(2) states: *The authority's investment strategy must include –*

a) a requirement to invest fund money in a wide variety of investments;

b) the authority's assessment of the suitability of particular investments and types of investments;

c) the authority's approach to risk, including the ways in which risks are to be assessed and managed;

d) the authority's approach to pooling investments, including the use of collective investment vehicles and shared services;

e) *the authority's policy on how social, environmental and corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and*

f) *the authority's policy on the exercise of the rights (including voting rights) attaching to investments.*

The Guidance issued by the Secretary of State in September 2016 includes six pages of Guidance in relation to the preparation of the ISS under Regulation 7(2).

The 2016 Investment Regulations and Guidance provide the freedom to LGPS Funds to invest in such assets as they consider appropriate through the removal of Schedule 1 to the 2009 Investment Regulations. The Regulations and Guidance also encourage LGPS Funds to carefully and proactively consider their strategic asset allocations. Whereas the 2009 Regulations merely required the SIP to cover *"the types of investments to be held"* Regulation 7(2)(a) of the 2016 Regulations state that a Fund's ISS must include "*a requirement to invest fund money in a wide variety of investments"*

The Guidance of September 2016 clearly encourages LGPS Fund's to adopt a genuinely diversified investment strategy and to avoid over reliance on any particular asset class and refers to a wide range of potential asset classes. It is however stated that *"this guidance does not purport to prescribe the specific asset classes over which fund monies must be diversified. This remains a decision for the individual administering authorities to make. Administering authorities are expected to be able to demonstrate that those responsible for making investment decisions have taken and acted on proper advice and that diversification decisions have been taken in the best long term interest of scheme beneficiaries."*

In clear contrast to the 2009 Regulations the 2016 Regulations positively promote an Environmental, Social and Governance (ESG) approach. Regulation 7(2)(e) states a Fund's investment strategy must include *"the authority's policy on how social, environmental and corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments."* The 2009 Regulations had a very different emphasis stating that the SIP must cover *"the extent (if at all) to which social, environmental or ethical considerations are taken into account in the selection, retention and realisation of investments."*

The Guidance of September 2016 further positively promotes an ESG emphasis and includes the following statement *"The law is generally clear that schemes should consider any factors that are financially material to the performance of their investments, including social, environmental and corporate governance factors…"* Furthermore the guidance states *"Although schemes should make the pursuit of a financial return their predominant concern, they may also take purely non-financial considerations into account provided in doing so would not involve significant risk of financial detriment to the scheme and where they have good reason to think that scheme members would support their decision."*

The September 2016 Guidance also positively promotes social impact investing including the statement *"……some part of the financial return may be foregone in order to generate the social impact. These investments will also be compatible with the prudent approach providing administering authorities have good reason to think scheme members share their concern for social impact, and there is no risk of significant financial detriment to the fund."*

In relation to ESG issues the Guidance states *"the Government has made it clear that using pension policies to pursue boycotts, disinvestment and sanctions against foreign nations and UK defence industries are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government."* This proposal which was contained in the Consultation of November 2015 resulted in a large response to the Consultation. 98% of the 23,516 responses received were from members of the public primarily in response to this proposal. The Guidance on *"…boycotts, disinvestment and sanctions…."* is however extremely unlikely to have any impact on the investment strategy of any individual LGPS Fund as the pursuit of a financial return is the primary criteria against which investment decisions must be made. The primacy of the financial return criteria has always been known to and abided by in the case of LGPS Funds and therefore it would seem unnecessary for the Government to have included the paragraph on boycotts, disinvestments and sanctions in the Guidance of September 2016.

In contrast to the 2009 Investment Regulations the 2016 Regulations by virtue of Regulation 7(2)(f) (in the words of the Guidance document) *"requires every administering authority to formulate a policy that reflects their stewardship responsibilities."* The Guidance positively promotes active stewardship stating *"Stewardship aims to promote the long term success of companies…. Stewardship activities include monitoring and engaging with companies…. Engagement by administering authorities is purposeful…."* The Guidance further states that *"authorities are encouraged to consider the best way to engage with companies to promote their long term success….."*

Notably the Guidance states that individual LGPS Funds *"should"* become signatories to the UK Stewardship Code *"and state how they implement the seven principles and guidance of the Code, which apply on a "comply or explain" basis"*. This Code which was issued by the Financial Reporting Council in July 2010 and revised in September 2012 aims to enhance the quality of engagement between investors and companies. This also represents a significant development as (based on research undertaken by the author of this paper) no more than 16 out of the 89 Administering Authorities in England and Wales had become signatories to the Code prior to the DCLG issuing its Guidance of September 2016. Furthermore the Guidance states LGPS Funds *"Should publish a report of voting activity as part of their pension fund annual report…."*

Regulation 7(2)(d) and the associated Guidance incorporate the requirement for LGPS Funds to delegate, in due course, the implementation of their Investment Strategy to an Investment Pool approved by the Government in accordance with criteria agreed by the Government. The Guidance requires each Fund to submit to the Scheme Advisory Board *“an annual report on the progress of asset transfers”* to their chosen Investment Pool.

In accordance with Regulation 7(6) each LGPS Fund must publish its (new) Investment Strategy Statement by 1 April 2017.

<u>Directions by the Secretary of State</u>

Regulation 8 provides that the Secretary of State may issue a Direction in relation to a LGPS Fund’s investment functions if (s)he *“is satisfied that the authority is failing to act in accordance with guidance issued under regulation 7(1).”* The Guidance of September 2016 both provides an explanation for the introduction of Regulation 8 and makes it clear that the power of intervention would only be used where, after due consultation and consideration, it is clear the Investment Regulations/Statutory Guidance have been breached. The Guidance *states “In relaxing the regulatory framework for scheme investments, administering authorities will be expected to make their investment decisions within a prudential framework with less central prescription. It is important therefore that the regulations include a safeguard to ensure that this less prescriptive approach is used appropriately and in the best long term interests of scheme beneficiaries and taxpayers.”*

The Guidance then states *“Where there is evidence to suggest that an authority is acting unreasonably, it may be appropriate for the Secretary of State to consider intervention, but only where this is justified and where the relevant parties have been consulted. Regulation 8 includes a number of safeguards, including full consultation with the relevant authority, to ensure that the proposed power is used appropriately, proportionately and only where justified by the evidence.”*

The Guidance also states that *“The Secretary of State’s power of intervention does not interfere with the duty of elected members under general public law principles to make investment decisions in the best long-term interest of scheme beneficiaries and taxpayers.”*

Based on the wording of Regulation 8 and the Guidance the power of intervention is definitely a reserve power which would not normally be utilised. A clear example of where it might however be applied is where a LGPS Fund refused to actively engage in Investment Pooling.

Investment Managers

The 2009 Investment Regulations contained four regulations relating to Investment Managers. These covered in detail their definition, choice, terms of appointment and review. In contrast Regulation 9 of the 2016 Investment Regulations alone covers the issue of Investment Managers. This represents a clear deregulation and granting of freedoms and flexibilities to individual LGPS Funds. Rather than the detailed prescriptive approach of the 2009 Regulations the new Regulation 9 simply requires that the Fund *"must reasonably believe that the investment manager's ability in and practical experience of financial matters make that investment manager suitably qualified to make investment decisions for it"* and that the *"authority must take proper advice in relation to the appointment and the terms on which the appointment is made."*

Transitional Provisions

Regulation 12(2) of the 2016 Regulations states that the requirements in relation to the maintenance of a Statement of Investment Principles and the restrictions on investment under Schedule 1 to the 2009 Investment Regulations *"continue to have effect"* until the Authority publishes its Investment Strategy Statement in accordance with (new) Regulation 7.

Conclusion

The 2016 LGPS Investment Regulations provide greater flexibilities and freedoms to LGPS Funds in terms of both their Investment Strategy and the appointment of Investment Managers (prior to Investment Pooling). The new Regulations place a clear emphasis on both ESG and Stewardship activity by the LGPS. The new Regulations put in place the regulatory framework for Investment Pooling in the LGPS. Although the new Regulations introduce an explicit power of intervention by the Secretary of State this is in the context of a less restrictive regulatory approach and clear guidelines/criteria which mean that such intervention would be rare and occur only where there was both a clear breach of the Regulations and after due consultation and consideration.

John Raisin

27 March 2017