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2 October 2023

Dear Sirs,

RE: Next steps on investments - open consultation

Dear Sirs,

Local Government Pension Scheme (England and Wales): Next steps on investments

Nottinghamshire County Council is the administering authority for the Local Government Pension Scheme (LGPS) within Nottinghamshire. The Nottinghamshire County Council Pension Fund has over 275 participating employers and over 149,000 members. The Fund had net assets of nearly £6.5bn at 31 March 2023 and had a funding level of 100% at the last triennial valuation. The Fund is a member of the Central pool and together with seven other LGPS funds has established LGPS Central Ltd as an FCA regulated company to manage investment assets on behalf of the Fund.

The Nottinghamshire County Council Pension Fund welcomes the consultation as an opportunity to discuss both the benefits and challenges of pooling and is pleased to contribute the following detailed comments on the consultation on the proposals as follows:

Asset Pooling in the LGPS

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?

There are significant benefits being realised through pooling, and the potential for further benefits. However the complexity of developing and governing pool companies and delivering investment vehicles suitable for a number of different LGPS Funds with differing liabilities and investment strategies should not be underestimated, especially with an FCA registered company and within the current market, legal and tax regime. It takes time to agree on fund mandates and to create them. Resources within both Pools and Pension Funds are limited and pooling is being progressed alongside multiple other requirements within the LGPS.

It should also be recognised that resourcing pool companies and transitioning assets is expensive. For funds with initial low costs it will still be some years, even decades before savings will be delivered (if at all), despite the forecast aggregated savings.

Nottinghamshire County Council Pension Fund Committee Members are concerned that any required extension of the pooling arrangements should be evidence-based for individual funds rather than based on aggregated projected figures.

Where reporting shows an increasing percentage of assets being pooled, pools should be left to progress at a speed which suits them. For the most part there are good reasons for assets not being pooled – either ongoing cost efficiency, suitable products not available (which will change over time), or costs of changing legacy assets.

There is a proposal to report on the reasons for retaining listed assets outside the pool – this could be extended to all assets.

Definitions of 'pooled assets' and 'assets under pool management' are welcome. It would be helpful if the definitions could be extended to clarify the position regarding assets in products pooled through a joint procurement exercise (which might or might not have preceded the formation of the pool company) or held with a shared custodian. For some pools these definitions will have significant implications. This will have an impact on the percentage of assets pooled figures which are quoted in the consultation document as these are not calculated on a consistent basis. As a partner fund to LGPS Central, ahead of the release of the consultation, we have been working collaboratively to move the LGPS Central pool forward, defining what pooling means to our Pool Partner Funds and shaping future direction and strategy for the Pool. Part of these discussions centred around the focus on percentage of AUM pooled. When products pooled by Pension Funds outside of the Company and advisory services are taken into consideration the real percentage of AUM pooled is considerably higher. It is disappointing to be named in the consultation document when this does not reflect the true picture of pooled assets. This demonstrates the need for clearer definitions and templates for data reporting to ensure there is consistency of approach throughout all LGPS pools.

The legal and tax arrangements regarding the transfer of legacy assets could be improved through exemptions to create no cost/tax free transfer arrangements between an LGPS Fund and its pool. Without these arrangements, the transfer of these assets will have to wait until legacy assets are closed or changed to enable the transfer to be made without excessive cost.

For FCA regulated pool companies it is clear that some FCA regulations do not reflect the nature of partnership working in pools. Some explicit exemptions for pool companies to certain requirements which do not make sense in this context would be welcomed.

The cost of operating a pool to meet all needs should be considered. Funds should be able to retain investments outside if the pool is unable to offer a more cost-effective alternative.

A focus on costs alone may limit the access to excellent but expensive investment managers and asset classes. The focus should move to value for money assessments and net performance. (This observation is also relevant to proposals on levelling up and Private Equity investments.)

The Nottinghamshire County Council Pension Fund is not convinced of the evidence 'that the benefits of scale are present in the £50-75 billion range and may improve as far as £100 billion.' The cited research was completed after a longer timeframe and concluded 'There is no straightforward causal relationship between AUM, cost and performance'. Indeed the funds in the Wales pool, the smallest of the eight by AUM, have over the five-year period only seen a 7.3% increase in costs, half the average across the whole LGPS per SF3 data to 31/3/22 provided to DLUHC. The Nottinghamshire County Council Pension Fund would like to see clear evidence and a reason for targeting £50–75 billion of AUM to justify the further costs, especially where it will only be achieved by merger.

If pools are to be aggregated (whether by merging pools, or by some closing and Funds moving to other pools) to achieve such scale, these changes <u>must</u> be actioned <u>before</u> further moves to pool assets or the transition costs are likely to double. The cost and time required to effect such changes will be significant and will delay further pooling of investments. If there is to be a required minimum pool size, clear guidance needs to be issued soon to give Funds confidence to transfer further assets to their pool. Nottinghamshire County Council Pension Fund Committee Members are concerned that larger pools could increase governance challenges and reduce the committee's influence, which might also have an impact on levelling up investment.

Question 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 2025?

A 'comply or explain' requirement, as described in the consultation, is deliverable to this deadline and could cover both listed and private investments. It would be helpful to receive further guidance from government on the degree of flexibility funds will have to retain investments outside the Pool, on the acceptable reasons for doing so, and on the obligations of pools to offer solutions.

There are many reasons why transitioning listed assets by this deadline is inappropriate:-

- A significant concentrated period of transitions could increase transition costs for all the LGPS.
- Pools will not have sufficient investment vehicles available by this date which would limit Pension Fund asset allocation. For example transition by this date would require the Nottinghamshire County Council Pension Fund to sell all its UK equities as LGPS Central does not have a UK equities fund. It takes time to design solutions in consultation with investing authorities, carry out any necessary procurement (fund managers and other service providers) and launch funds, so more time is required.
- It should also be recognised that there will be specific asset classes where the pool has insufficient expertise and insufficient scale to justify creating investment vehicles. Again enforcing a transition would limit the options for asset allocation.
- Pooled fund fees may exceed existing fees on external products.
- Pooled fund performance may not match external funds.
- Some listed assets might not be sufficiently liquid and again, enforcing a deadline would increase costs.
- The market environment might make it a poor time to transition certain holdings, especially important if it is not possible to transition to an equivalent strategy withing the pool.

In all these cases, pension funds need to consider their fiduciary duty which is likely to make it impossible for them to comply.

The definition of whether assets are considered 'transitioned' or 'pooled' needs clarifying.

Careful thought is also required on passive assets. In response to the pools being set up, passive managers significantly cut their fee rates, and these assets are now managed under LGPS umbrella commercial agreements (in some cases with pools having oversight of the assets). This severely limits any possibility to reduce fees further by moving these assets within the pool once the pools' fees are added on. The low passive-management fee rates also make it difficult for pools to develop in-house passive capabilities as cost effectively. These would also suffer from lost benefits of scale. The benefits of pooling have hence already been achieved. Recognition of this through an appropriate definition of a pooled asset would be helpful for passive assets.

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?

Pools are gradually evolving and making progress. It is not clear that additional guidance of this sort would speed things up and might have the opposite effect.

Value for money needs to be considered. We have previously chosen to compromise moderately on asset allocation within a class (such as by region), risk levels and cost to enable investment in a pooled product, and always consider our pool's products for investment before looking anywhere else, but there are limits to the acceptable level of compromise and cost within our fiduciary duty.

The recognition that setting investment objectives, risk appetite and high-level investment strategy remain with the funds is welcome. These are the most important investment considerations for any long-term investment fund, so it is critical that these decisions remain with pensions committees as long as they are responsible, and therefore have a fiduciary duty, to pay pensions.

Staff at pools were appointed as investment experts - many do not understand the links to pensions liabilities which drive asset allocation decisions so are not necessarily qualified to advise on strategic asset allocation. 'Investment strategy' needs a very clear definition to avoid this aspect being misunderstood. And as investment managers there is potential for a conflict of interest in offering such advice.

The requirement to pool assets appears to be at odds with some of the other proposals in the consultation. We need clear guidance on priorities between

- pooling assets (could be more expensive and may not offer UK listed, smaller company or PE investments),
- achieving cost savings (levelling up and Private Equity investments are likely to be more costly. Pooled assets may charge higher fees than legacy arrangements.)
- investment in UK smaller and private companies. (LGPS Central does not have a Small Companies fund nor investments in buyout or venture funds. Nottinghamshire County Council Pension Fund's UK smaller private equity investments, including some included or similar to those quoted in the consultation examples, are too small for LGPS Central to be interested in).

This prioritisation is essential to avoid contradictory regulations if all these proposals are retained. Detailed responses are outlined in individual questions, but Nottinghamshire County Council Pension Fund suggests that investing in private equity should not be a requirement in the regulations, and levelling up investments are best dealt with through producing an impact report. As the pools exist to deliver cost savings, where these cannot be delivered through pooling assets this should be an acceptable reason to retain assets outside the pool. Similarly local and levelling up investments should be able to be held outside the pool where this provides the best outcomes.

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?

Yes. However this might best be pursued through the implementation of the Good Governance recommendations which is awaited with anticipation.

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?

Nottinghamshire County Council Pension Fund is in favour of consistent reporting in the Annual Report. This needs to be consistent with the CIPFA model accounts to reduce duplication of effort. It requires clear definitions on asset classes, pooled assets and savings figures. (Please also see the request for definitions in the response to question 1).

The timing of the first year of changed reporting needs sufficient advanced warning and requires a break from other changes at the same time.

Reporting against a consistent benchmark sounds good in theory, but it might be difficult to make it work in practice. There is a risk that it says more about the investment strategy difference to the benchmark than the performance of the funds. E.g. a fund with a higher allocation to the UK over the last 10 years (such as our own) would look comparatively bad against a global benchmark.

Actual savings from pooling for an individual Pension Fund will be different from the forecast figures previously reported. Because of the upfront costs these could show as a net cost for many pension funds.

Nottinghamshire County Council Pension Fund does not agree with reporting on levelling up investments in the annual report due to the time (and hence cost) required to undertake this exercise. A three yearly impact report would be easier to accommodate – please see response to questions 7, 9 & 10.

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

Yes, this should flow naturally from the proposals for Fund annual reporting referred to in Question 5.

LGPS investments and levelling up

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

The definition requires detailed knowledge of existing underlying investments to make the assessment of whether the requirement is met for reporting purposes. This will be time consuming, especially on the first occasion. Resourcing this will be challenging and this analysis should not be required more than once every three years rather than on an annual basis.

A review of the examples of levelling up investments was particularly interesting for the Nottinghamshire County Council Pension Fund as we are mentioned, as are funds similar to those we already invest in. The solar farm quoted has taken much more staff resource to manage than an investment of this size could possibly justify. This was quoted as delivering 'a good return on investment' – in the current interest rate environment this is less convincing. Two other examples are investments in Foresight local funds. Nottinghamshire County Council Pension Fund also invest in a Foresight fund and other similar funds managed by YFM and is considering investing in Foresight's new Midland fund. However the Fund is unable to invest in any of these funds through our pool as their scale (which is very appropriate for the sector of the market) is too small for the pool to consider. The government needs to decide whether the priority is pooling or investing in levelling up and growth PE for smaller companies. Please see response to question 3 and the need for clear priorities.

Creating additional investment opportunities, potentially in collaboration with the British Business Bank could help here.

It would be helpful to have clarity between ‘levelling up’ and ‘local’ investments as the terms seem to be used interchangeably. The Nottinghamshire County Council Pension Fund Committee Members are supportive of investments in the local area which contribute to levelling up, as long as this is not inconsistent with meeting the objectives of the Pension Fund. The broader definition of levelling up across the UK is likely to be more supportive of investment returns. Both levelling up and local investments could be in multiple asset classes.

There are several risks to pools setting up local investment funds.

- There can be conflicts of interest with local projects as local councillors may seek to influence investment for reasons other than investment returns. The involvement of pools can help with this, but not entirely mitigate it.

- It would be helpful if such funds were prevented from including restrictions in the mandate to allocate by region in any way. Within Central there has been suggestion that a local fund would need to invest in all the counties/areas within the pool. This restriction would impact returns.
- The 'local' area may not have sufficient investment opportunities to provide good investments. The Nottinghamshire County Council Pension Fund has invested in smaller companies at points over the last couple of decades and the UK wide funds have generally performed better than the areas with more geographically restricted areas. Having said this, the importance of investment managers having local offices cannot be overstated.
- The implementation capacity and abilities as described in the consultation may simply not exist. Resourcing at local government and pension funds has been significantly constrained, and pools may not have been set up to enable this role.
- The costs of this kind of investment are significant. Nottinghamshire County Council Pension Fund sees the benefits in net returns for well managed investments, but the high costs add to the risks in this difficult sector of the market.
- Our existing best performing local and small business investment managers are of no interest to the pool because their funds are too small.
- And finally, setting up a new fund within the pool is very time consuming. If we stop making investments outside the pool while we wait for a new pooled fund it would delay our investment into this sector of the market.

The guidance needs to reflect the highest priority – is this to pool assets, reduce costs or to invest in levelling up? If this is not clear there could be unforeseen consequences. Should local and levelling up investments be an acceptable rationale for holding investments outside the pool?

Question 8: Do you agree that funds should be able to invest through their own pool in another pool's investment vehicle?

Yes - for the types of investments provided in examples E.g. GLIL or 'national' projects or where pools choose to collaborate.

Question 9: Do you agree with the proposed requirements for the levelling up plan to be published by funds?

Although Nottinghamshire County Council Pension Fund is supportive of the levelling up agenda generally, creating a levelling up plan seems inappropriate. The purpose of the LGPS is to invest to secure pension payments for members, and to manage the cost of the scheme to employers, principally local government organisations, not to achieve levelling up, which as mentioned in para 59 of the consultation, cannot be done by Pension Funds alone. Better would be a levelling up impact report, produced periodically (say every three years) to assess the impact of fund investments. Just reporting on this would incentivise funds and pools to have something to report and would have impact without confusing the objectives of the scheme.

Broadly Nottinghamshire County Council Pension Fund is supportive of the high level aims of this proposal (as can be demonstrated by our current investments mentioned in the response to Question 7), but meeting the Fund's fiduciary duty is paramount so all investments must contribute to delivering returns without incurring excessive risk or cost. Such investments must create attractive risk adjusted returns. This sector of the market is inherently risky and needs managing by experienced managers (who need local contacts) at an appropriate scale (which appears to be inconsistent with pooling) and with an appropriate investment mandate. Some previous local funds have performed poorly because investment constraints have been inappropriately set. Or it needs a form of government underwriting to reduce the risk.

Because this sector of the market is risky, it will not be an appropriate investment for all funds.

The terms "up to 5%" and “may exceed 5%" make this figure meaningless. The ‘target’ figures are in any case superfluous. Merely the act of reporting will stimulate interest in such investments.

Question 10: Do you agree with the proposed reporting requirements on levelling up investments?

Please see the response to Question 9. On the proposed definition the approach is too time consuming to analyse on an annual basis and should be no more than a three yearly report. This should be a levelling up impact report, rather than a report against a levelling up plan, which could confuse the objectives of the scheme.

Investment opportunities in private equity

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? Are there barriers to investment in growth equity and venture capital for the LGPS which could be removed?

Nottinghamshire County Council Pension Fund already has a target to invest in Private Equity which is reviewed as part of our asset allocation which has been gradually increasing over time. This asset class includes some of the current investments mentioned in the Levelling Up section.

Pension Fund Committee Members are concerned that being pushed rather than choosing to invest substantial sums into levelling up and illiquid private equity may be in conflict with the pension committee’s duty to secure the best return for pension fund members. Furthermore, stepping up investments in illiquid Private Equity, would need enhanced due diligence, as firms are not as highly regulated as listed companies and are harder to sell and value.

A clear definition here would be helpful – is this Private Equity, or private markets? Nottinghamshire County Council Pension Fund‘s total private markets investment is considerably higher than just Private Equity investments. Any pension fund needs to balance the total allocation to private markets to ensure sufficient liquidity.

It should be noted that Nottinghamshire County Council Pension Fund’s current 6% allocation has been in place for some time, and has committed nearly 7% to funds, including LGPS Central's PE funds, but is still only 3.2% invested. The time delay between commitment and investment is significant. Consequently, whatever funds choose to allocate to this area will not be reflected in the figures for some time.

Nottinghamshire County Council Pension Fund has a further commitment to smaller companies. It’s not clear why there is a wish to encourage investment in unlisted companies rather than listed ones (given smaller unlisted UK investments are already covered in the previous section on Levelling Up), and any additional investment in Private Equity would be funded from the allocation to listed equity.

For many funds an ambition of 10% (in Private Equity and Private Markets) would be inappropriate. This is a high risk and high-cost investment. The Nottinghamshire County Council Pension Fund believes the target ‘ambition’ figure should be removed together with any requirement to invest in this asset class.

Private equity is a high-cost investment. The dichotomy of reducing costs and investing in private equity needs to be recognised and, as referred to in the response to question 3, if these are included in the regulations a clear prioritisation is required so Pension Funds are not left breaching regulations whatever action they take. Although Nottinghamshire County Council Pension Fund currently see value in investing in Private Equity we do not agree that this should be a requirement under the regulations.

Nottinghamshire County Council Pension Fund is supportive of the removal of barriers to investment in UK growth equity and venture capital. The British Business Bank could make significant contributions to the availability of suitable investments if it can operate at sufficient scale. The challenge is sourcing sufficient investment opportunities without moving to larger companies (the challenge the pools are facing) or including less promising investments (assuming BBB are currently investing in the best available - doubling (for example) the investment capital on this basis would reduce average returns).

There is significant overlap between this ambition and the one relating to local and levelling up investment.

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?

Nottinghamshire County Council Pension Fund would welcome both parties being supported to collaborate - but please see the previous points.

Improving the provision of investment consultancy services to the LGPS

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

Yes.

Updating the LGPS definition of investments

Question 14: Do you agree with the proposed amendment to the definition of investments?

Yes, Nottinghamshire County Council Pension Fund agrees with this amendment.

Public sector equality duty

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?

It should be noted that 72% of the Nottinghamshire County Council Pension Fund members are female and most members of the LGPS receive only small pensions. Although there would be no immediate impact on member contributions or benefits, the cost cap exercise means that these could change if the costs of the Fund increase, which some of these proposals could do if Funds are required to (for example) use pooled funds at additional cost, or if investment returns suffer (for example by requiring investments in riskier asset classes beyond the funds' investment strategy). To avoid a risk of this it should be explicit in the guidance that increased costs is a sufficient reason not to pool, and that funds should not take excessive risks.

Key messages

Nottinghamshire County Council Pension Fund believes that there should not be a deadline for transitioning listed assets, but a comply or explain regime is introduced instead. Guidance on acceptable reasons for holding assets outside pool companies would be welcome, alongside clear definitions of pooled and transitioned assets. As the pools exist to deliver cost savings, where these cannot be delivered through pooling assets this should be an acceptable reason to retain assets outside the pool. Similarly local and levelling up investments should be able to be held outside the pool where this provides the best outcomes.

Nottinghamshire County Council Pension Fund suggests that investing in private equity should not be a requirement in the regulations, and levelling up investments are best dealt with through producing an impact report.

Yours faithfully,

Nottinghamshire County Council Pension Fund