

4 December 2012

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Local Government Pension Scheme - Investments  
Department for Communities and Local Government  
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Dear Chris

### **Local Government Pension Scheme: Investments in Partnerships Consultation**

Thank you for the opportunity to comment upon the Department's consultation paper which seeks view on the merits of amending the Investment Regulations to provide further flexibility in the area of investment in limited partnerships.

As you know, CIPFA, via the Pensions Panel, has long had an interest in the Investment Regulations and has in the past worked with the Department to ensure that the Regulations keep pace with the latest developments in local government pension fund investment practice.

We are therefore pleased to note that the Department is seeking to act upon the limitations placed upon LGPS funds efforts to diversify the range of investments by coming forward with specific proposals regarding the limits placed upon investment in limited partnerships. As the consultation document recognises, a number of alternative investment types, such as infrastructure funds and private equity, are delivered through partnership structures. As the use of these types of investment grows within the LGPS, the existing limit may act as a barrier to some funds in executing their preferred investment strategies.

That said, we are disappointed that the Department has not taken this opportunity to go further in addressing the wider concerns of LGPS practitioners regarding the Investment Regulations as set out in our report of January 2009 (copy enclosed) and reiterated in the February 2012 submission by the practitioners who took part in the Department's Investment Regulations Working Party during 2011 (Annex A).

Whilst we would naturally support raising or removing the limit on investments in partnerships as being a step in the right direction as set out in our previous submissions, on its own the impact will be relatively limited. Based on the latest CIPFA/WM LGPS investment statistics, only around 25% of funds are at or approaching a 15% fund allocation across all alternative investments which will of course include those not delivered through a partnership structure such as hedge funds, commodities etc. DCLG could have a far greater impact on the ability of funds to invest more flexibly and manage risk more effectively if it were to expand the remit of the current consultation to look at the solutions proposed in the February 2012 submission.



INVESTOR IN PEOPLE

I hope these comments are a useful contribution to the development of the Investment Regulations. As ever, if you would like to discuss further any of the points raised, please do not hesitate to contact CIPFA via the Pensions Panel Secretary, Nigel Keogh, at [nigel.keogh@cipfa.org](mailto:nigel.keogh@cipfa.org).

Yours sincerely

A handwritten signature in black ink that reads "Alison Scott". The signature is written in a cursive, flowing style.

Assistant Director, Policy and Technical

### **Response to CLG Informal Consultation on Local Government Pension Scheme Investment Regulations**

1. It is recognised by all interested parties that the existing regulations do not meet the current needs of Local Authority Pension Funds in enabling funds to effectively manage their investment risks and meet their long term return objectives. Because the regulations have been built on and consolidated over time, they reflect what might have been appropriate in 1998 with some minor amendments but are not fit for purpose in today's investment world. Amending the existing regulations might resolve some current problems, but leave regulations open to interpretation, especially if amended regulations retain a fixed definition of "investment". This approach will result in continued uncertain consequences and probably the regulations needing further amendment in the near future. Any suggested changes come back to using the relevant parts of the Occupational Pension Scheme (Investments) Regulations to provide the appropriate definitions, which raises the question of why not adopt these as a practical replacement.
2. The general view is that the preferred route is to replace the current Local Authority Pension Funds investment regulations with the Occupational Pension Scheme (Investments) Regulations (suitably amended for the public sector context) and with any appropriate adjustments to ensure in particular that LGPS funds are not subject to other aspects of the IORP Directive which would cut across other parts of LGPS specific legislation, especially on funding.

This is presented as a deregulation initiative, a simplification of the current arrangements and application of more transparent arrangements. This would meet Government objectives for justifying regulatory change.

An analysis of the application of the OPS(I) Regulations in terms of their governance requirements relative to local government has been carried out by Clifford Sims (Squire Sanders LLP) and set out below.

3. CLG are rightly concerned about ensuring there is appropriate governance of LGPS funds in place to ensure all funds are well managed. There have been few reported private sector breaches of the OPS(I) Regulations and on the rare occasions where there has been a breach (usually in relation to the self-investment rules), the OPS(I) Regulations have proved to be a robust framework, which would serve as an appropriate base for any future LGPS arrangements.
4. With the move to IFRS-based accounting standards for LGPS funds, the disclosures required under IFRS 7 present a high degree of transparency with regard to the use of financial instruments and the identification and management of risk associated with them. Funds are required to provide both quantitative and qualitative narrative commentary on financial risk, including the

risks associated with the use of derivative financial instruments. However DCLG could take this opportunity to embed, in regulation, specific governance requirements, reflecting the unique nature of LGPS funds.

5. This could take the form of an annual monitoring report, published with the annual report or as an integral part of the already required investment report, which specifically requires funds to demonstrate how they have ensured compliance with the regulations. CIPFA would be prepared to assist in providing guidance to practitioners on how to compile such a report.

**INVESTMENT REGULATION REVIEW GROUP: GOVERNANCE COMPARISON BETWEEN THE LGPS AND PRIVATE SECTOR SCHEMES**

	<b>Private Sector Schemes</b>	<b>LGPS</b>
	<b>References to Regulations are to the Occupational Pension Schemes (Investment) Regulations 2005</b>	<b>References to Regulations are to LGPS (Management and Investment of Funds) Regulations 2009)</b>
Knowledge and Skills of Trustees/Officers in relation to investment and other related matters	<p>Sections 247-248 Pensions Act 2004 ("PA04") require trustee knowledge and understanding of:</p> <ul style="list-style-type: none"> <li>• Law relating to pensions and trusts</li> <li>• Principles relating to funding of occupational pensions schemes</li> <li>• Principles relating to investment of assets and</li> <li>• Trustees must be conversant with trust deed and rules, SIP, statement of funding principles and any other documents recording policy for the administration of the scheme</li> </ul> <p>S247(5) Degree of knowledge and understanding is that "appropriate for the purposes of enabling the individual properly to exercise his functions as trustee of any relevant scheme?"</p> <p>TPR Code on TKU (November 2009) sets out detailed Regulator guidance.</p>	<p>CIPFA knowledge and skills framework (January 2010) - non-statutory</p> <p>Same principle applies with minor drafting changes.</p>

	<b>Private Sector Schemes</b>	<b>LGPS</b>
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	IGG Principle 1 (for DB schemes) requires that "Trustees should ensure that decisions are taken by persons or organisations with the skills, knowledge, advice and resources necessary to take them effectively and monitor their implementation".	
Qualification of Trustees/Officers; Governance Principles	Investment Governance Group ("IGG") Principles (2008)  Voluntary, but TPR endorses a comply or explain approach.	IGG Principles adopted October 2009  Reg 12(3) requires SIP to reflect extent to which administering authority complies or explain why not.
Statement of Investment Principles ("SIP")	S35 Pensions Act 1995("PA95") Reg. 2 prescribes contents.  Breach of s35 (failure to obtain/maintain a SIP or taking advice before preparing SIP): penalties under sections 3 and 10 (civil penalties and prohibition on acting as trustee).  Revision at least every 3 years and "without delay" after any significant change in policy.	Reg 12. Contents as for private sector schemes except for additional requirement to state policy on stocklending.  No penalty for breach of Reg. 12  Revisions from time to time, but must be made within 6 months of any material change to policy (Reg 12(5))

	<b>Private Sector Schemes</b>  <b>References to Regulations are to the Occupational Pension Schemes (Investment) Regulations 2005</b>	<b>LGPS</b>  <b>References to Regulations are to LGPS (Management and Investment of Funds) Regulations 2009)</b>
	Trustees must consult employers before preparing.	Authorities have to "consult with such persons as [they consider] appropriate" when preparing SIP. Arguably they could choose not to consult.  Query: under Reg 11(1) an authority must formulate a policy for the investment of its fund money: how is this different from the SIP?
Managing Assets/Appointing a Scheme Fund Manager	<p>The Financial Services and Markets Act 2000 ("FSMA") requires persons who carry on a regulated activity (such as managing investments) to be authorised or exempt. Trustees are deemed to manage investments by Article 4 of the FSMA, because the activity involves managing assets belonging to another person and the exercise of discretion.</p> <p>However, the FSMA (Carrying on Regulated Activities by Way of Business) Order 2001 Article 4 provides an exception to the requirement to be authorised if trustees delegate day to day decisions to an authorised or exempt person under FSMA.</p>	<p>Reg 8(1) administering authority "may" appoint one or more investment managers, "instead of managing and investing fund money itself".</p> <p>Therefore an LGPS fund can manage investments itself without requiring FSMA authorisation. Presumably the logic is that the LGPS fund assets belong to the authority not another person.</p> <p>Regs 8-10 set out criteria where managers are appointed.</p>

	<b>Private Sector Schemes</b>  <b>References to Regulations are to the Occupational Pension Schemes (Investment) Regulations 2005</b>	<b>LGPS</b>  <b>References to Regulations are to LGPS (Management and Investment of Funds) Regulations 2009)</b>
	<p>S47(2) PA95 appointment prescribes that trustees must appoint an authorised fund manager.</p> <p>No equivalent.</p> <p>No equivalent.</p> <p>No equivalent.</p>	<p>Where external managers are appointed Reg 8(5) requires an "adequate number" of managers and the fund must be proportionally divided between managers.</p> <p>Reg 9: termination of manager not more than 1 month's notice; manager must report every 3 months and be reviewed by the authority (Reg10(1)); manager must take account of diversification, suitability and the SIP.</p> <p>Authority must take "proper advice" in determining manager's terms of appointment.</p>

	<b>Private Sector Schemes</b>  <b>References to Regulations are to the Occupational Pension Schemes (Investment) Regulations 2005</b>	<b>LGPS</b>  <b>References to Regulations are to LGPS (Management and Investment of Funds) Regulations 2009)</b>
Liability/Duty of Care	<p>Section 33(1) PA 95 states that "liability for breach of an obligation under any rule of law to take care or exercise skill in the performance of any investment functions... cannot be excluded or restricted by any instrument [ie trust deed] or agreement".</p> <p>Section 34(6) PA95 says, however, that trustees are not responsible for the act or default of any fund manager to whom discretion has been delegated if they have satisfied themselves that</p> <p>(a) the fund manager has appropriate knowledge and experience for managing the scheme's investments and</p> <p>(b) he is carrying out his work competently and complying with s36(choosing investments.)</p>	<p>No liability/duty of care provisions, presumably because (a) delegation is voluntary and (b) the investments are not held under a trust and the benefits are guaranteed, so no need for a duty of care to the members (or others) to be expressed.</p> <p>Reg 8(3) mirrors s34(6) tests: the authority "must reasonably believe that the investment manager's ability in and practical experience of financial matters makes that investment manager suitably qualified to make investment decisions for it".</p>
Advice	S36(3) PA95 Trustees must take "proper advice" before investing in any manner.	Reg 11(5): general requirement on authority to "obtain proper advice at reasonable intervals about its investments".

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	<p>Proper advice is defined in s36(6) as that of "a person who is reasonably believed by the trustees to be qualified by his ability in and practical experience of financial matters and to have the appropriate knowledge and experience of the management of the investment of trust schemes".</p>	<p>Reg 11(6): "authority must consider such advice in taking any steps in relation to its investments".</p> <p>Reg 14(3) &amp; 15(2): proper advice must be taken when increasing limits under Schedule 1.</p> <p>Reg 2(1) contains an almost identical definition: "the advice of a person whom the authority reasonably believes to be qualified by their ability in and practical experience of <u>financial matters (including any such person who is an officer of the administering authority).</u>" (emphasis added).</p>
Suitability/diversification	<p>S36(1) PA 95 originally required trustees to have regard to the need for diversification and suitability. The 2005 Regulations replaced the suitability criteria with detailed criteria in Reg 4 taken from the IORPs Directive.</p> <p>Diversification is now covered by Reg 4(7); "the assets of the scheme must be properly diversified in such a way as to avoid</p>	<p>Regs 9(5), 10(4) and 11(2) all require diversification and suitability to be taken into account by any appointed investment manager and by the authority in reviewing that manager's performance.</p>

	<b>Private Sector Schemes</b>  <b>References to Regulations are to the Occupational Pension Schemes (Investment) Regulations 2005</b>	<b>LGPS</b>  <b>References to Regulations are to LGPS (Management and Investment of Funds) Regulations 2009)</b>
	<p>excessive reliance on any particular asset, issues or group of undertakings and so as to avoid an accumulation of risk in the portfolio as a whole. Investments in assets issued by the same issuer or by issuers belonging to the same group must not expose the scheme to excessive risk concentration."</p> <p>The overarching principles are that the power of investment "must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability as a whole" (Reg 4(3)) and in a "manner appropriate to the nature and duration of the expected future benefits payable under the scheme" (Reg 4(4)).</p> <p>Reg 4(5) and (6) require scheme assets to be "predominantly held in investments admitted to trading on regulated markets" and, for those which are not to "be kept to prudent levels".</p>	<p>No equivalent requirements.</p>
Audit	S47(1)(a) PA95 requires all funds to appoint an auditor.	LGPS Admin Regs 2008 (Reg 33(1)).
Asset Classes	The only specific asset classes which are mentioned in Reg 4 are derivatives (defined broadly by reference to the MiFID terms of	See Regulation 3 and Schedule 1.

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	<p>reference) and a clarification that collective investment schemes and life policies are deemed to satisfy the test of being regulated market investments for the purposes of Reg 4(5).</p> <p>Reg 4(8) requires that investments in derivatives may only be made if the (a) "contribute to a reduction of risks" or (b) "facilitate efficient portfolio management (including the reduction of cost or the generation of additional capital or income with an acceptable level of risk)". Also, derivatives must be made and managed to "avoid excessive risk exposure to a single counterparty and to other derivative operations."</p>	
Borrowing	Reg 5(2): trustees may only borrow for the purpose of providing liquidity and on a temporary basis. Trustees cannot act as a guarantor if the liability is to be satisfied out of the scheme assets.	Reg 5: broadly similar except that there is a 90 day limit on borrowing and the purposes for borrowing are restricted to (a) paying benefits due or (by) meeting "investment commitments arising from the implementation of a decision by [the authority] to change the balance between different types of investment".

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		No reference to guarantees.
Separate Bank Account	Section 49(5) PA95	Reg 6.
Restrictions on employer-related investments	S40 PA95 and Regs 11 – 13: detailed rules on holding no more than 5% of scheme assets directly or indirectly in the employer.	Footnote to Reg 14 cross refers to the Occupational Pension Schemes 2005 Regulations and says that they "may further restrict or limit investment of fund money".  Although the legislation is not entirely clear, it appears that the LGPS would satisfy the definition of an occupational pension scheme for the purposes of s40 PA95.