Appendix 2

Warwickshire Pension Fund

LGPS (England and Wales) Next Steps On Investment

Consultation Response

21st September 2023

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?**

- As a partner fund within the Border to Coast Pensions Partnership pool, our pool has not only complied with, but is considered by the pool's Joint Committee to be meeting all the original aims of the Government's 2016 pooling strategy.
- It is important that requirements imposed on Administering Authorities (Funds), which limit or hinder their ability to meet current and future Fund liabilities, do not create conflicts of interest which the Funds cannot navigate. Where proposals are made that do create an actual or potential conflict, for example prescribing that Funds should invest in certain assets or type of assets, or that Funds must invest via pools, etc, it would be helpful for Funds to have clarity on what is the priority. New requirements and objectives should at least be articulated in a way as to allow Funds enough discretion that Funds can still meet their fiduciary duty, should there be a conflict, for example through "comply or explain" approaches.
- It is important to recognise that Administering Authorities have responsibility for liabilities and the management of governance as a whole, not just investments, and they have the ultimate fiduciary duty to pay pensions. Administering Authorities need to be able to focus on ensuring pensions can be paid and not have to compromise on this in order to deliver other objectives.
- A recognised risk is whether there is adequate resourcing and sufficient ability to recruit the right capabilities within Funds.
- We believe that a separation of duties should continue between Funds and Pools, to minimise conflicts of interest and to maintain challenge, e.g. we believe there could be conflicts of interest for Pools taking on the core strategy advisory roles within Funds, and there will always be a need for independent strategy advisors.
- This said, scale can deliver benefits. A 2022 publication by CEM looked at the case for scale for pension schemes. Its findings were that asset pooling led to lower staff costs per assets invested (due to the ability to internalise certain investment capabilities) and to lower external management fees (due to the negotiating strength that comes from the value of mandates being placed, negotiated by professional investors whose interests are aligned with the ultimate asset owners).
- This is supported in the recent paper "Scale Economies, Bargaining Power, and Investment Performance: Evidence from Pension Plans" (March 2023). This research demonstrates the benefits of economic scale in pension plan investments (particularly those with in-house investment capabilities): large plans have stronger bargaining power over their external managers in negotiating fees as well as access to better-performing funds, relative to small plans. They use this power to produce higher gross and net-of-fee return performance, particularly in private asset classes. Economies of scale in investment costs are particularly large

for passively managed accounts and for publicly traded assets and are significantly lower for actively managed accounts and alternative (private) asset classes.
- However, scale doesn't always deliver additional benefits; seeking scale without addressing issues such as good governance, a common vision and culture (within the Pool and among Partner Funds), complexity of investment strategies, and client needs, can either inhibit, or damage, a pools ability to deliver.
- Delivering the benefits of pooling can be challenging and requires an understanding at officer and elected member level of both the benefits and costs of compromise, and an ability to assess where such compromise does not have a material impact on the risk/return profile that we as a Fund wish to achieve. However, there is acknowledgment that Pools must be able to provide products that service the diversity profile of the liabilities of each Fund they support.

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?**

- We support the principle of transferring, or having a clear path to transition, assets to pools. However, we believe March 2025 is too short a timescale to impose as a hard target. Products will need to be developed within pools to allow the suitable transition of assets, but forcing this to happen by this date has the potential to cause significant avoidable transition costs and risks.
- We would welcome clarity on the position of legacy illiquid assets particularly those in private markets. With fees already negotiated, and with typically no ability to adjust them post commitment, transferring these assets to the pool may simply incur new legal and tax costs. It may be more appropriate to agree that individual Partner Funds should not seek to make new illiquid investments outside their pool from this date, and the pools (where appropriate) support Partner Funds on the oversight of legacy illiquid assets as they run-off. This could be on a case-by-case basis – for example it is possible to transition UK Real Estate assets with appropriate tax planning and achieve strong investment and business case benefits, though this may not be able to take place before March 2025 without causing significant avoidable transition costs.
- We would also welcome clarity on 'passive' investments. In our pool's current arrangements, Funds have a commercial arrangement across a range of index' funds in large, liquid and low-cost pools. These assets benefit from oversight from Border to Coast, and there is no obvious value for them to be replicated within the Pool. We believe that these investments should continue to be considered pooled ("assets under pool management").
- We also note the current guidance that up to 5% of assets can be invested outside the pool. We believe this flexibility should remain – particularly as this allows Funds to ensure fiduciary duties are met whilst encouraging the opportunity to making local investments where suitable.

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?**

- Through Border to Coast we have developed a model of pooling which has successfully allowed us to meet the government's objectives for pooling. We support the approach set out in the consultation, which is reflective on the manner in which we have sought to pool. Nonetheless, we would urge caution on being overly prescriptive in describing any model in guidance as doing so would bring with it the risk of stifling innovation and the ability of Partner Funds and pools to respond to changing circumstances.

- We would prefer that new requirements that impose new objectives onto Funds (e.g. stating Funds must invest in certain assets etc) are kept to a minimum as they will make it more difficult for Funds to innovate and to meet their fiduciary duties by reducing flexibility.
- We believe that within the Border to Coast pool we have been compliant with the government's intentions and so would not want to be the subject of directives intended to ensure non-compliant Funds and pools change their approaches.
- We believe that strategic asset allocation, and Fund investment strategy should remain with LGPS funds who have responsibility for the liabilities, and Funds can then commission investments primarily through pools.

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, we already have a training policy, and we already report against it in the annual report.
  - It is important to ensure decisions are made by the right people, with the right level of knowledge, at the right time.
- Due to the natural political cycles, turnover of Pension Fund Committee Members results in challenges with knowledge retention in the decision-making body.
  - The LGPS needs to consider how to recruit and retain committee members with appropriate skills given the significant responsibilities the committee holds.
  - The knowledge and understanding of Pensions Committees may be supported by independent advisors who can act in a role akin to Non-Executive Directors (who should be set clear objectives in such a role) but cannot be a replacement – and may play a key role in supporting the Committee in their responsibilities in the oversight and scrutiny of the investment strategy by the pool.

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?**

  - We support the proposal to have standard reporting requirements (with clear and consistent definitions). We would welcome this is progressed as part of the Good Governance project. We would also welcome a complete review of the regulations to simplify and streamline processes.
  - We support the reporting of net savings, but definitions would need to be modernised to the most appropriate benchmarks or comparators.
  - Any standardised reporting on asset performance would need to be designed such that it is at a level and in a form where comparisons are meaningful and are reported in a way that does not incentivise Funds to make sub optimal decisions.
  - In addition to reporting aimed at highlighting performance, there needs to be reporting on pool performance.
- What is the added value of an increased and standardised reporting framework?
- Is there a benefit to members of producing information for scheme members of individual asset class performance? E.g. against the Asset Liability Modelling risk/return metrics. This is already done to a certain extent by SAB, CEM benchmarking
- Risk-adjusted net returns is the most important investment objective for a Fund, more important than fee saving. What is the need to consolidate responses from all AAs? Consider liability benchmark too, e.g. Longevity

- Who decides on the level of granularity of asset classes?

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

- We support clear and consistent reporting by the Scheme Advisory Board, provided the Board is sufficiently resourced to undertake the work and it is undertaken in such a way as to minimise the data collection burden on us as Funds.
- We also note the broader issue of increased reporting for the LGPS. The research in "LGPS: Views from inside the scheme" found that over half (54%) of respondents feel that the legislation/regulatory requirements are too complex to execute, while two in five (43%) continue to feel legislation/ regulatory requirements hinder them from doing their job effectively.
- This is not to diminish the fundamental role of transparency and reporting. This is essential to ensure accountability, and to drive best practice across the LGPS. However, simplicity is key. Partly driven by the scale and complexity in current reporting requirements, we understand a recent review by SAB suggested that nearly a third of LGPS funds were not meeting their annual report disclosure requirements.
- Simply adding additional reporting requirements not only adds cost, but there is a significant negative impact for the intended audience of the scheme members due to the volume and complexity of information being published. We believe that the impact assessment of changes in guidance – in terms of cost, transparency, and in the ability of readers to interpret what is shared – should be taken in the context of the ongoing review of LGPS reporting requirements being undertaken by the Scheme Advisory Board.

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

- Any arbitrary rule about how to invest makes it harder for Funds to deliver our purpose of being able to set funding strategies, with an appropriate level of risk-adjusted return, to meet current and future liabilities, in line with our fiduciary duty. If an investment opportunity naturally meets the Fund's risk/return objectives, then we will naturally invest without the need for prescription, but Funds need to have the freedom to choose this in line with our statutory responsibilities.
- Through our Pool, Border to Coast, a new private markets strategy, 'UK Opportunities' is being developed anyway. Set to launch in April 2024, this will provide us with opportunities to invest in the regions across the UK, including venture and growth capital, and will ultimately support the policy intent outlined in the Levelling Up white paper, if this fits with our funding strategy.
- Under current guidance, we have the flexibility to invest up to 5% outside of pools anyway. The local and specific nature of these investments mean they may be of a small scale and unable to be effectively delivered through the pool. As such, this exemption to making these investments outside of the pool should be maintained (although this should still be subject to regulatory permissions, resourcing, recognising the importance of managing conflicts of interest that may still arise, and the role pools can play in advising in relation to non-pooled investments).
  - We agree with the definition outlined in the consultation.
  - We would reiterate the comment that it would be more positive to allow Funds enough flexibility to avoid Funds having to compromise on meeting their fiduciary duty in order to achieve levelling up objectives, should there be a conflict.

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

- Yes, this would open up a wider opportunity set to LGPS Funds and therefore increase the likelihood of Funds being able to meet their investment objectives through LGPS pools.
- This could be a positive option to have available. We also support the Government's view that this approach, if used, should promote choice and centres of excellence, and not be driven by competition, the focus should be on collaboration. This could allow further economies of scale in certain asset classes that would naturally benefit from this as an alternative approach to increasing pool size to gain efficiency, without the potentially significant cost of merging pools. This could allow pools to specialise in certain asset classes and be recognised as 'best in class'.
- It would potentially allow further economies of scale in asset classes that seem to benefit from this.
- This would allow access to products that a Fund's Administering Authority's own pool has not yet developed, and avoids additional resources being used to recreating something that already exists within the LGPS pools.

- However, it needs to be recognised that there are several implications that need to be fully considered and risks mitigated. These include issues such as:

  - *Proposition development* – currently propositions are designed with, and for us by our Pool where we are both a shareholder and a customer. Care will be required should external pool customer(s) wish to evolve existing propositions. The existing governance structures and processes may need to be reviewed to overcome this challenge.
  - *Niche strategies* – certain investments may have capacity issues. For example, despite significant demand, the initial Climate Opportunities strategy was capped at £1.35bn. Care will be required in balancing the needs of shareholder customers vs external pool customers for capacity constrained investments.
  - *Cost model* – as shareholders, we principally manage risk through Border to Coast's regulatory capital. As non-shareholders, external pool customers would be subject to different pricing.
  - *Managing demand* – in owning and building Border to Coast, there has been a structured approach to its growth –building capacity and capability to reflect our long-term needs. This is likely to be absent with non-shareholder customers and, in accepting external customers, there is a risk of managing in- and out-flows, potentially destabilising the Pool's ability to plan the required capacity in various functions of the business. There are also similar considerations regarding management of liquidity in certain propositions.
- There would need to be appropriate arrangements in place to promote collaboration and to ensure that the governance arrangements in pool are appropriate.

- There would need to be clarity around fee structures in these circumstances, ensuring that fees remain transparent and fair.
- Pools managing additional customers will require careful consideration, particularly noting the potential additional layer of due diligence costs that will be required as a regulated asset manager investing into another regulated asset manager's vehicle.
- There would need to be clarity around how demand is managed by pools.
- We would want the whole of the LGPS to do well and would want any arrangements to have that objective in mind.

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

- We do not agree with this proposal, as this potentially does not support the fiduciary duty of funds, it is simply imposing additional burdens and costs on the LGPS to support UK Government policy objectives.
- There would be challenges in reporting information consistently. Any investment strategy and associated reporting on Levelling Up would need to be through the principal asset classes (e.g. Real Estate, Private Equity, Infrastructure, Private Credit, etc). This ensures that the risk-adjusted returns are considered on the same basis.

Funds already have to produce and publish their funding strategies, which clearly set out our liabilities, the risk-adjusted returns we are seeking to satisfy those liabilities, and the strategic asset allocations that best deliver the funding strategy defined. Adding a requirement around levelling up to this has the potential to cause conflict for some funds with our fiduciary duty to pay current and future pensions.

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

- No in that this would be additional reporting on a matter that is not a core LGPS objective and would cause resourcing implications for Funds.
- To the extent that there are reporting requirements they would need to be simple to administrate.
  Based on our response to question 9 i.e. not agreeing with the need to have a published levelling up plan, we don't feel it necessary to comment on the potential reporting requirements as these don't add value to Funds' fiduciary duty and this simply adds unnecessary costs to Funds.

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?**

- No. As open DB pension schemes, it is essential that LGPS Funds develop appropriate diverse investment strategies designed to balance risk and return to ensure the LGPS remains affordable with stable employer contributions. Funds should be free to determine their Strategic Asset Allocation without constraints that tie them to other objectives that could be conflicting with a Fund's main objective. In the current financially volatile environment, it is also important that employers have stability in their contributions rates, which strategic asset allocations also support. Imposed asset allocations like this could risk more instability.
- Funds should be free to determine our Strategic Asset Allocation without constraints, based on our assessed level of liabilities and the appropriate level of risk-adjusted returns needed to ensure we can fund our liabilities, when they fall due.
- There is the potential for arbitrary constraints like this to cause a conflict with Funds' fiduciary duty to pay pensions on time.
- Private markets (and all asset classes) can play a role in this, but requiring all Funds to have to have a certain amount of a certain asset will cause sub-optimal decision making.

- Should there be any directive, the broader it is the less risk of poor decision making it will cause.
- If Government decides to implement a requirement, any defined allocation should be to private markets globally rather than purely private equity, as simply focusing on private equity is likely to create more of an issue for a higher number of funds through risk concentration than using private markets. Could this 10% allocation be to private markets rather than just private equity?
- Rather than imposing arbitrary targets, the most effective way to encourage any investment in the UK is the provision of a stable investing environment through policy certainty. If the LGPS and private capital is being asked to make large, long-term, capital investments, the Government needs to offer corresponding long-term guarantees and/or the necessary policy certainty to protect these potential investors. Examples include policy certainty on renewable energy, transport and other climate transition considerations; improvements to the planning regime to accelerate development opportunities and to enable clearer partnership opportunities with Local Authorities; and the development of structures (perhaps with the support of BBB or UKIB) that enable risk sharing or return visibility.
- The optimal allocation to private equity (or any asset class) may will vary over time and should be considered as part of a full Strategic Asset Allocation.

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?**

- There are a range of potential partners that could support the LGPS pools to deliver growth capital in the UK. The British Business Bank (BBB) is one of many experts in the private capital market, whilst it could be unwise to ignore their expertise, there are many other sources which are equally relevant in this space.
- Given their state ownership and strategic focus to 'crowd in' other investors, these institutions may be well placed to support the LGPS pools source and commit to ventures that meet our normal investment criteria. However, the BBB was only established in 2018, so does not yet have an established track record that its fund is able to perform in line with returns available elsewhere from other more established providers, which will be a consideration in any engagement.
- We do note that one of the key objectives of LGPS pooling was to reduce the fee burden paid by pension funds, and in a private market context, reduce the reliance on fund of fund structures which introduce an additional layer of fees and carry (profit share) expense. As such, any vehicle should be offered on a cost only basis if the intention is to encourage greater participation in this part of the market. Additional fee load will detract potential investors who are sensitive to fees. BBB will be investing balance sheet capital into all investments so a successful investment policy will deliver profitability for them without a reliance on fee income.

  - Noting our comments in previous bullet points it is important that any partner to the LGPS has the appropriate capacity, capability, and fee structure to support the implementation of our investment strategies. Without this, this could be another unhelpful constraint for Funds and Pools.

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

- We already meet the CMA review criteria with an annual review of consultants and advisors, so this wouldn't present an issue for us, and we'd welcome a consistent approach across the sector.
- If advisory work was to be done through Pools in the future, we believe LGPS pools should have the same requirements as any other investment consultants or advisors. However, we believe pools would have significant conflicts of interest if advising on investment strategy and implementing the strategy.
- We have a very strong view that there will always be a need for independent advisors regardless of who is providing the core advice, given there are potential conflicts of interest for any core advisor, the type of conflict simply differs depending on whether it's a specialist consultancy firm or a Pool.
- There would need to be independent checks on advice received from pools, either that is provided by an investment consultancy or through internal expertise e.g. an independent adviser, as the conflict of interest in having responsibility for assets but not the liabilities is a significant issue.

Question 14: **Do you have any comments on the proposed amendment to the definition of investments?**

- No.

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.**

- No.