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Rt. Hon Brandon Lewis MP
Parliamentary Under Secretary of State for Communities and Local Government
Eland House
Bressenden Place
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Dear Minister

The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (the "Regulations")

As you may know, the Department for Communities and Local Government has for the last few years held regular meetings of a Review Group to consider the regulatory framework for LGPS fund investments, and in particular the efficiency of the Regulations in the light of market and other developments.

A consistent theme of the practitioners of the Review Group (who are made up of LGPS funds, CIPFA, and leading actuarial, legal and investment experts) has been to call for either the repeal or a substantial re-drafting of the Regulations because they are no longer deemed fit for purpose. In the light of the responses to the recent Call for Evidence, the separate advice your Department taken with the Cabinet Office under the Contestable Policy Fund, and the emergence of plans for the use of collective investment funds in the LGPS, the Review Group believe that it is time to address this question again and to take that initiative forward in a more concrete way.

The reasons why the Review Group has suggested that the Regulations should be replaced are broadly as follows:

- The control exercised by the Department, provided by the Regulations, works through a combination of limits placed on particular legal forms of investment, which imposes a somewhat arbitrary diversification of the underlying investment risks. Separate governance controls are provided in the form of requiring the relevant administering authority (which has the power to control investments) to take advice if it wishes to increase these limits. The advice can be provided by an officer of the authority and need not be independent.

- By definition, prescribing particular types of legal vehicle addresses the form rather than the substance of the underlying investment. The Regulations are regularly "worked around" to achieve a particular investment strategy, i.e. the allocation limits are seen as compliance obstacles rather than providing an efficient risk diversification matrix, which was the original purpose of the limits when they were introduced in the 1980s. These “work-arounds” can reduce transparency and potentially lead to an incomplete picture of the risks within an investment portfolio.

- By restricting investment in certain types of vehicle, but not in others, either because those new vehicles have been introduced as a result of change in the law, such as the authorised contractual scheme, or because foreign vehicles are used which are not directly comparable to English law structures, the Regulations produce either confusion (as to how to categorise particular investments) or they can effectively be ignored, because they are silent on a particular form of investment. Confusion brings additional and avoidable legal cost. Where the Regulations are silent or contain no express limit, the post Localism Act position is that there is freedom to invest, so there may need to be some other internal governance control operating to avoid unnecessary concentration of risk, but the Regulations do not achieve this.

The Review Group has suggested that an alternative prudential framework would be more appropriate for imposing both governance and prudential safeguards in relation to LGPS investments. The simplest way of achieving this would be to adopt the model used by the Occupational Pension Schemes (Investments) Regulations 2005, as amended. These regulations map the requirements of the IORPs Directive for private sector schemes and have worked well since their introduction. The prudential regulatory approach taken under these regulations is that scheme trustees must have regard to the following factors: the security, quality, liquidity and profitability of the portfolio scheme as a whole, as well as the nature and duration of the expected future retirement benefits payable under the scheme. The private sector model also constrains schemes by reference to investing on unregulated markets and addresses the question of excessive reliance on a particular asset, issuer or counterparty for derivative purposes.

Naturally, there are important differences between a funded private sector scheme and an LGPS fund which should be fully reflected in any revised Regulations, but it is difficult to see that an LGPS fund could argue with any of these over-arching principles in setting an investment strategy.

I should mention that the support across practitioners in the LGPS and in the industry for reforming the Regulations has a long history; before the last substantial changes were made in 2009, the Department consulted with the industry and CIPFA prepared a very detailed quantitative report from LGPS managers which supported the case for change then. I believe that the main reason why no significant change was made at the time was nervousness about the volatility of the investment markets following the financial crisis of 2008. Investment volatility has become a fact of life and, arguably, giving funds greater freedom to employ different investment techniques to counter that volatility would contribute to a more efficient prudential framework which should reduce rather than increase risk.

If the Minister agrees with this recommendation, the necessary powers to amend the Regulations already exist under the Superannuation Act 1972; regulations could be laid before Parliament under the negative procedure after the appropriate consultation period.

Yours sincerely

Nigel Keogh
On behalf of the LGPS Investment Regulations Review Group