

8 February 2016

Victoria Edwards
LGPS Reform
Department for Communities and Local Government
2/SE Quarter, Fry Building
2 Marsham Street
London
SW1P 4DF

Dear Victoria

Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 – November 2015 Consultation

Thank you for the opportunity to comment on proposals to enhance the effectiveness and operation of the current regulations which govern the management and investment of local authority funds in England and Wales.

As a funded pension scheme the investment regulations need to provide sufficient flexibility for local authority funding and investment strategies to secure diversified investment returns for the payment of scheme liabilities. At the same time the regulations need to have an accountability, governance and transparency framework which reflects the schemes public sector status and the multi-employer base.

CIPFA has long had an interest in the investment regulations. In January 2009 CIPFA submitted the findings of a wide ranging survey of practitioner views and conclusions and recommendations from these findings. This report raised the principle of moving away from prescribed asset limits and moving to a prudential approach. This followed principles established through the previous publication of a Code of Practice for Treasury Management. The need for a prudential approach to LGPS investment has been a theme mentioned by CIPFA in the various consultations on the regulations in recent years. CIPFA welcomes the proposed establishment of this approach in the 2016 regulations.

The importance of knowledge and skills to the establishment of a prudential approach has been a key point for CIPFA in previous consultations. CIPFA has published Knowledge and Skills frameworks for elected representatives and non-executives in the Public Sector and Pensions Practitioners, a Code of Practice and a statement on the role of the Chief Financial Officer in the Local Government Pension Scheme. This has recently been supplemented by a Knowledge and Skills framework for local pension boards. CIPFA considers that these frameworks and the Code of Practice are essential elements for a Prudential Code which CIPFA believes should accompany the proposed 2016 regulations.

The importance of LGPS funds securing strong investment returns within a diversified and risk assessed framework is ever more important with the current cost pressures facing local government following the latest CSR. Increasing demand for statutory services and an aging population are set against severe reductions in funding from previous financial settlements and the additional pressure from the latest CSR. The LGPS has around 11,000 different employers. Most of these will be affected by reduced government funding for local authorities.

LGPS employer costs of £6.9bn for England in 2014 – 2015, are a material item of inescapable cost for all local authority budgets. The cost has to be funded and adds to the complexity of painful decisions which now have to be made about service priorities affecting local communities and the services they value and need. At an individual employer level, dependant on the local funding position and recovery of past deficits, employer costs can represent 20-30% of pensionable pay or even more, a very significant cost. The level of investment return achieved and future projections along with the actuarial assessment leading to review of the employer contribution rates is an issue of keen interest to all employers and stakeholders with an interest in the scheme.

With this background CIPFA welcomes and fully supports innovative thinking on the efficiency of the LGPS and sees the proposed approach to the investment regulations as a key element in the future management of the scheme.

CIPFA has commented separately on the "Local Government Pension Scheme: Investment Reform Criteria and Guidance" issued in November 2015. The proposed establishment of a small number of asset pools requires the changed approach to the investment regulations outlined in this consultation.

As requested CIPFA has provided comments in response to the specific questions in your consultation in the attached Annex.

I hope these comments are helpful. If you would like to discuss further any of the points raised, please do not hesitate to contact me or Neil Sellstrom (neil.sellstrom@cipfa.org).

Yours sincerely



Rob Whiteman
Chief Executive

Annex

Q. 1. Does the proposed deregulation achieve the intended policy aim of removing any unnecessary regulation whilst still ensuring that authorities' investments are made prudently and having taken advice?

Q.2. Are there any specific issues that should be reinstated? Please explain why.

Q.3. Is six months the appropriate period for the transitional arrangements to remain in place?

Q.4. Should the regulation be explicit that derivatives should only be used as a risk management tool? Are there any circumstances in which the use of derivatives would be appropriate?

CIPFA welcomes the proposed deregulation approach. It has long been recognised by all interested parties that the existing regulations do not meet the current need of local authority pension funds to effectively manage investment risks and meet long term return objectives. Amending the existing regulations might resolve some issues but still leave the regulations open to interpretation. The proposed introduction of asset pools has highlighted the need for a changed approach to the regulations.

As CIPFA reported in 2009 the imposition of investment limits predated other risk mitigation and management measures such as funding strategy statements, statements of investment principles and adoption of the Myners principles. With these came requirements to take appropriate market, risk and investment advice and to consult with stakeholders. Most recently, the introduction of Local Pension Boards has strengthened fund oversight and governance.

The other change since the current regulations were introduced has been the strengthening and emphasis on funds having the requisite knowledge and skills and the development of practitioner support through CIPFAs Pension's Network and the work undertaken by the Shadow Scheme Advisory Board, now the Statutory Board. CIPFA considers that this backdrop of increased knowledge and skills, networking and scrutiny are essential elements to the deregulated approach in the investment regulations.

CIPFA has strongly advocated that investment decisions should only be undertaken within a framework which ensures that those making decisions and exercising governance are able to do so with full knowledge and understanding.

The need for knowledge and understanding in the LGPS led to the publication by CIPFA in 2010 of *Knowledge and Skills Framework - Technical Guidance for Pensions Practitioners* and *Knowledge and Skills Framework - Technical Guidance for Elected Representatives and Non Executives*.

These frameworks were strengthened by elevation to CIPFA Code of Practice status in 2013. This means that compliance with the frameworks is a professional requirement for all CIPFA members and members of other professional accountancy bodies. Additional work by CIPFA led to the publication in 2014 of a statement on "*The role of the Chief Finance Officer in the Local Government Pension Scheme*". And, most recently CIPFA published in 2015 a "*Knowledge and Skills framework for members of Local Pension Boards*".

There is consequently a strong professional requirement for knowledge and skills and CIPFA has stressed that the CFO is required to ensure that this responsibility extends to all those involved with managing the LGPS.

The other development recently has been the Pensions Regulators requirement in the statutory Code of Practice "*Governance and administration of public sector pension schemes*" for local Pension Board members to have knowledge and understanding.

When the Shadow Schemes Advisory Board's guidance on the creation and operation of local Pension Boards was being prepared the question arose of whether knowledge and skills should be a pre-requisite for members of the administering authorities Pensions Committee. This was not resolved.

The continuing discussion on MIFID 11 and the key question of enabling funds to operate as professional, rather than retail investors is also highlighting this issue, with the need to demonstrate knowledge and skills as a professional investor.

CIPFA considers that knowledge and skills for members of Pensions Committees who will now be applying the proposed deregulated approach to investment management should be a requirement in the 2016 investment regulations and scheme guidance.

CIPFA is fully supportive of the approach to deregulation of the investment regulations but would also point out that it needs to be seen in the context of public sector accountability and transparency. When local authority borrowing controls were replaced with a prudential approach, similar issues arose to those needing to be considered now for investment management. This resulted in the publication of guidance notes and a code of practice. CIPFA would be interested to discuss with LGPS stakeholders how a prudential code for investment management could be developed. This would enable best practice to be outlined with guidance to enable local application.

CIPFA is pleased to see that the consultation paper outlines a proposal to remove the requirement for the performance of investment managers to be reviewed every three months. CIPFA fully endorses the recommendations from Professor John Kay's review of UK equity markets and long term decision making.

CIPFA notes that Ministers are satisfied that the scheme is consistent with the national legislative framework governing those responsible for making investment decisions. CIPFA assumes that this addresses the points raised by Nigel Giffin QC in his opinion to the Shadow Scheme Advisory Board dated September 2014 on the *Financing and Regulation of the Local Government Pension Scheme*.

CIPFA is supportive of the proposed Investment Strategy Statement which replaces the existing Statement of Investment Principles. The latter together with the Funding Strategy Statement are documents which provide accountability and transparency as well as being key management tools.

CIPFA would ask that the requirement in the 2009 Regulations to state compliance with the Myners principles is also included in the Investment Strategy Statement. Detailing compliance against the Myners principles demonstrates public accountability for a scheme's governance principles and should be an essential part of the regulations. CIPFA notes that draft regulation 7(1) mentions guidance is to be issued by the Secretary of State. When this is available CIPFA will examine the detailed content of the Investment Strategy Statement. Subject to the requirements of this guidance CIPFA has no comment to make at this stage on the proposed six month transitional period.

When commenting in 2009 on derivatives CIPFA advised that these were an important tool in effective fund management and the management of risk. CIPFA's 2009 report and subsequent conversations showed that there was a wide variation in the interpretation of what derivatives were permitted with varying degrees of confidence in the interpretation of the regulations reflected in attitudes to how funds approached derivative investments. Different advisers take different views on the permissibility of derivative investments.

CIPFA supported including in the LGPS investment regulations a general power to use derivatives such as that contained in the Occupational Pension Scheme Investment Regulations. These permit investment in any derivatives as defined in the EU markets in Financial Instruments Directive. This is subject to such instruments only being made in so far as they contribute to a reduction of risks or facilitate efficient portfolio management (including the reduction of cost or the generation of additional capital or income with an acceptable level of risk). This remains CIPFA's view and is a wider definition than that proposed in the 2016 regulations.

Q.5. Are there any other sources of evidence that the Secretary of State might draw on to establish whether an intervention is required?

Q.6. Does the intervention allow authorities sufficient scope and time to present evidence in favour of their existing arrangements when either determining an intervention in the first place, or reviewing whether one should remain in place?

Q.7. Does the proposed approach allow the Secretary of State sufficient flexibility to ensure that he is able to introduce a proportionate intervention?

Q.8. Do the proposals meet the objectives of the policy, which are to allow the Secretary of State to make a proportionate intervention in the investment function of an administering authority if it has not had regards to best practice, guidance or regulation?

Whilst CIPFA understands why the Secretary of State is seeking these intervention powers if the stage were reached where it was felt necessary to apply these powers it would raise an important issue of accountability. This is particularly complex with the large number of employers who could be participants in a particular scheme and the external advisers involved. CIPFA appreciates that this is the same issue which arises where powers of intervention are used outside of the LGPS.

The emphasis given in the consultation to the prior stages before intervention is noted. A stage not mentioned, but which has been mentioned by the Shadow LGPS Board in the context of supporting funds is the possibility of a nationally available supportive team being available to help funds. This could be achieved on an informal, directed or requested basis and is an option which CIPFA would be pleased to discuss further.

It is important that before the stage is reached where intervention is required that sufficient clarity is available on potential grounds for the involvement of the Secretary of State. This is especially important for the LGPS with the scheme complexities and the involvement of external advisers with their own accountabilities. As an example, mention is made of an unsatisfactory report under Section 13(4) of the Public Services Pensions Act 2013. CIPFA is aware of the continuing discussions with GAD and the local authority actuaries on the interpretation of Section 13(4) on matters such as consistency, solvency and cost efficiency. This raises issues of professional judgement and who should be accountable to the Secretary of State.

CIPFA considers that the role of the Scheme Advisory Board is fundamental and is fully supportive of the work already undertaken on deficit management and key performance indicators. This work needs to be completed and review/ reporting arrangements installed before intervention should be considered. If intervention is being considered fund data and comparisons needs to be sound and free from any distortion.

Integral to this is work being undertaken to the reporting of investment and management costs. CIPFA published in 2014 "*Accounting for Local Government Scheme Management Costs*" for application to accounts from 2014 -2015. This has recently been reviewed and an update to the guidance will be published shortly. Creation of asset pools, dependant on the actual structure, might involve compliance with corporate and local authority accounting requirements. Irrespective of the accounting and disclosure framework there will be a need to demonstrate transparency and consistency of approach for pool comparisons and subsequent analysis. This raises an issue of compliance and the status of advice. The current advice has good practice status, compliance being a matter of local judgement. Although CIPFA has urged funds to adopt the advice it is clear from analysing 2014- 2015 accounts that it was not universally applied. Consideration is being given to elevating the status of the guidance for 2015 2016 and whether there should be mention in Accounts and Audit regulations.

CIPFA will continue to work on fund accounting and disclosures to improve fund accountability and transparency and provide data for pool cost and performance comparisons, again all pre requisites before intervention.