Appendix 'C'

Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 Consultation - Response by the Lancashire County Pension Fund

Introduction

Lancashire County Pension Fund welcomes the opportunity to respond to the Government's proposals to make changes to the Local Government Pension Scheme Investment Regulations. The Fund is one of the largest in the LGPS with over 150,000 members working for around 230 employers and with around £5.8bn of assets under management.

In general the Government's proposals represent a welcome move away from over detailed prescription which limits the ability of funds to execute the most effective (and indeed cost effective) options for the delivery of their investment strategies. Our comments seek to ensure that the regulations provide the clarity that will be required by counter parties in ensuring that Funds have appropriate powers to enter into transactions. We also strongly welcome the introduction of the Investment Strategy Statement to replace the Statement of Investment Principles and the Funding Strategy Statement. For us this represents a significant step forward and will encourage funds to properly articulate the rationale for their strategic asset allocation in the context of addressing their liabilities.

As a fund which was one of the first to embark on the journey to create an asset pool for investment purposes we clearly welcome the removal of the schedule 1 limits. However, the reserve powers which it is proposed that the Secretary of State should exercise do seem particularly broad and extend well beyond the area of management and investment of funds amounting in fact to a general power of intervention. Whether such a broad power of intervention is required is something that should be debated in its own right and not in the context of the Government's view that a power is required to encourage pooling where funds are failing to follow this direction.

To us the provisions in relation to non-financial factors seem unnecessary. We are not aware of any significant evidence of the sort of practices suggested in the consultation document. Given that the Government is proposing to rely on the common law test in relation to fiduciary duty surely the same test would achieve the objective sought by the Government.

Turning to the specific consultation questions:

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

   In general terms the answer here has to be yes. The overall approach of allowing administering authorities to set their own risk appetite and investment mix through a more prudential approach supported by proper advice is something that is long overdue. However, history indicates that investment counterparties when dealing with public bodies require some specific assurances in terms of power to enter into particular transactions. The draft regulations clearly seek to free up the investment universe and the Government's intention is clear. In order to make this clear to counter parties, however, it may be helpful to add in at relevant points some language along the following lines, e.g. "for the avoidance of doubt derivatives should be taken to include, but not be limited to…" This is perhaps to exercise an abundance of caution, but will provide clarity for counter parties who tend to exercise significant caution when dealing with public bodies whose activities are constrained by statute.

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

   No, our feeling is that by moving to a regime more akin to that for private sector funds the draft regulations represent the appropriate way of regulating this area of activity placing an emphasis on the need for Pension Fund Committees acting in the same way as trustees to exercise prudence and appropriate judgement acting with proper advice.

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

   This seems appropriate and manageable, although given the proximity to the results of 2016 valuation becoming available and impacting on investment strategies there could be a case for extending the transition period until the point at which the valuation comes into operation. There is also a case for providing a somewhat longer period to allow pooling proposals to be effectively encompassed in the new Investment Strategy Statement. However, on balance we feel that the new Investment Strategy Statement represents a major step forward in scheme governance and will provide much needed clarity for stakeholders and therefore favour the Government's proposal which probably represents the shortest possible transition across the breadth of the scheme.

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

   There are a number of ways, in addition to risk management, in which derivatives could be used within the execution of Funds' investment strategies. The most obvious is in the delivery of passive equity strategies where it is possible to simply buy index futures in order to achieve the same returns as a passive manager. This approach is in general terms cheaper than a traditional manager in order to achieve the same results.

   "Use" of derivatives also needs to be effectively defined. Sensible hedging strategies may involve both the buying of instruments (which would be usually accepted as being a form of investment) and the selling of others. The ability of funds to do the latter has sometimes been questioned, although interestingly not the ability of managers acting on behalf of funds. Therefore providing absolute clarity on this would be extremely helpful.

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

   The issue here is less the evidence base than the nature of the intervention power. The power proposed is much more widely drawn than a power simply to ensure that all funds pool their investment assets. It is, in fact drawn as a general power of intervention, and the evidence base indicated supports this.

   We make no argument for or against such a general power, although we would contend that there is no evidence such a power is required. However, we would strongly argue that the Investment Regulations are not the place for such a power within the overall governance framework and that the introduction of such a wide ranging power, which as far as we are aware does not exist in other locally administered schemes, requires proper debate in its own right rather than as part of a major package which is focussed on fundamentally changing how LGPS funds are invested.

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?*

   This seems appropriate and reflects the approach in other intervention regimes.

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

   The range of interventions in relation to investment strategy set out in the consultation document seem to give an appropriate range and it would be anticipated that the directions issued to give effect to them would add appropriate light and shade to what the Department is seeking to achieve through a particular intervention.

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 regard to best practice, guidance or regulation?*

   The range of choices available seems to cover the whole range of those available.