LGPS Fit for the Future

Consultation Response

January
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Introduction

As a provider of investment services to funds within the LGPS we welcome this opportunity to respond to the MHCLG consultation on proposed reforms to the scheme.

We will limit our comments to areas of the consultation where we have specific expertise, in sustainable investment provision, and base it on our experience of working closely with LGPS clients for many years.

This response is also informed by a piece of original research on the management of climate related investment risk in the LGPS, undertaken in 2021. It follows our response to the LGPS: Next steps on investments consultation in 2023, which the government states has informed the current proposals.

Titled, LGPS: Fit for the Future – the consultation seeks to aid the Pensions Review with its twin objectives of improving pension outcomes and increasing investment in the UK. It is our firm belief that any future-proof pension scheme targeting strong member outcomes must be invested in a sustainable manner and consider financially material risks arising from Environmental, Social and Governance (ESG) issues, such as climate change.

Summary Response

The new proposal does not address one of the fundamental challenges with the pooling project thus far. Principally, our feedback to this consultation is that the government's proposals and approach to pooling in the LGPS, since the initial guidance in 2015, has suffered due to a lack of focus on sustainable investment beliefs at fund level. In a model where funds retain responsibility for high-level investment objectives, including sustainable investment strategy, but where pools are not alliances created on those high-level beliefs, asset pooling will remain problematic.

An area where this has become apparent is in the management of "passive" listed assets in line with a variety of different approaches to managing climate risk and target setting.

Within the current LGPS decision-making structure, it must be ensured that there is enough variety available in terms of investment strategy implementation such that underlying funds can invest according to their values and beliefs and in line with their fiduciary duty, not least when it comes to sustainable or climate aware investing.

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Consultation Response

Question 1: Do you agree that all pools should be required to meet the minimum standards of pooling set out above?

The consultation paper notes that the government aims to "*put the LGPS on a clearer, firmer trajectory to scale and consolidation, as well as measures to improve scheme governance and investment*". However, the proposal does not address one of the fundamental challenges with the pooling project thus far.

In a model where funds retain responsibility for high-level investment objectives, including sustainable investment strategy, but where pools are not alliances created on those high-level beliefs, asset pooling will remain problematic.

Our research on the management of climate related investment risk in the LGPS[1] shows that the success of the pooling project was hampered by not considering sustainable investment in the early stages. This has led to a lack of unity on certain key issues such as net zero policy and created problems for pools in aligning sustainable investment strategies and making available appropriate investment vehicles that meet the needs of their diverse partner funds.

The initial guidance on pooling was published in 2015. This is significant in that it was also the year that the Paris Agreement was established, following which governments, companies and investors began to appreciate the material financial risks associated with climate change. In 2018 the IPCC published the 1.5ºC Special Report[2], highlighting the potential economic pathways to a future aligned with the goals of the Paris Agreement. What followed was a substantial shift in the way that institutional asset owners approached sustainable investing. The Net Zero Asset Owner Alliance was established in 2019 and a swathe of tools and guidance for setting 'Paris aligned' or 'Net-Zero aligned' investment strategies became available, such as the Science-based Targets Initiative (SBTi), Transition Pathway Initiative (TPI), Climate Action 100+, the Institutional Investors Group on Climate Change (IIGCC) and others.

The LGPS was at the forefront of this sustainable investing revolution. Recent research shows that 49% of LGPS Funds have set a Net Zero target or ambition[3]. But the funds' strategies for achieving those goals vary greatly with differing philosophies, approaches and target dates, ranging from 2030 to 2050. Half of funds do not currently have a net zero commitment. Pools are not

[1] Juliff (2021) The Management of Climate Related Investment Risk in the UK Local Government Pension Scheme - available on request

[2] Summary for Policymakers — Global Warming of 1.5 ºC

[3] LGPS funds make progress on net zero, but majority lack targets, according to XPS Group's latest research | XPS Group

alliances that were created based on sustainability or net zero policies.

Design and execution of climate policy in the pools is therefore challenging. To co-invest, funds must agree on a strategy. If they all have different approaches and targets, pooling loses its purpose.

Under the current pooling model, a one-size-fits-all approach is not reasonable due to the decision-making hierarchy, variation in local stakeholders and different interpretations of fiduciary duty and sustainable or responsible investing.

Question 2: Do you agree that the investment strategy set by the administering authority should include high-level investment objectives, and optionally, a high-level strategic asset allocation, with all implementation activity delegated to the pool?

The effective interaction between funds and pools enabling full delegation and transfer of legacy assets is reliant on an alignment of investment beliefs. This concept remains largely absent from the consultation document.

The investment strategy and asset allocation set by a fund is informed by its financial ecology, influenced by multiple stakeholders. Therefore, funds are more likely to delegate to a greater degree if the pool can offer strategies aligned with their investment beliefs. This relies on pools being able to deliver low cost, core investment strategies which can be designed and managed with agreed and transparent sustainability and risk criteria.

A more optimal differentiating feature between pools and alliances might be according to sustainable investment beliefs, such that funds can find the right alignment for their investment strategies.

Question 3: Do you agree that an investment strategy on this basis would be sufficient to meet the administering authority's fiduciary duty?

The pooling model was built upon the principle that local authority funds remain individually responsible for investment strategy and delivery of benefits to members, and pools are responsible for implementing investment strategies. The consultation states that the template provided for strategic asset allocation recognises that AAs retain fiduciary duty.

However, if underlying partner funds are not aligned in terms of investment beliefs and targets then pooling assets is more difficult to achieve as different investment vehicles are required. **An area where this has become apparent is in the management of "passive" listed assets in line with a variety of different approaches to managing climate risk and target setting.**

It has been widely reported and discussed that there is "no consensus" across the LGPS funds and pools on how to manage climate risk[4] . This is most apparent in the approach to net-zero target setting across the scheme.

Our research demonstrates that there is no such thing as passive Paris alignment[5]. It is therefore challenging for pools to manage the fund level diversity in targets and strategies, particularly in the areas the government suggests should be pooled quickly or perhaps managed in house, such as listed equities – which often represent the bulk of assets.

Within the current LGPS decision-making structure, it must be ensured that there is enough variety available in terms of investment strategy implementation such that underlying funds can invest according to their values and beliefs and in line with their fiduciary duty, not least when it comes to sustainable or climate aware investing.

For example, pools could make different core equity strategies available, which may not be entirely based on simplistic and systematic portfolio decarbonisation. Some funds may decide to integrate certain red lines around their investment universe, relating to activities such as human rights violations, the fossil fuel value chain and corruption and others may take a less exclusionary approach. This could allow partner funds to access investment vehicles that better align with their objectives, may create more constructive partnerships and lead to greater scale in pooled assets. Importantly, it may allow more effective delivery of "value for money" to beneficiaries.

Question 7: Do you agree that administering authorities should be required to transfer all listed assets into pooled vehicles managed by their pool company?

As detailed above, for funds to effectively invest in line with their fiduciary duty they must be able to access strategies that align with their investment beliefs and objectives.

Expecting all funds in one pool to invest in the same 'passive' Paris aligned core listed equity strategy is particularly problematic as there is no single definition of Paris alignment.

Despite attempts by the EU to define the rules of a Paris Aligned Benchmark (PAB) or Climate Transition Benchmark (CTB), there is a considerable difference in risk exposures and performance depending on which brand of PAB or CTB is selected. This means funds can be exposed to unknown, unintended and unmanaged risks in the very part of their portfolio which is designed to be low governance.

Further, different funds may take different approaches to align with their beneficiaries'

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[4] Revealed: the council pension funds with net-zero target dates | Local Government Chronicle (LGC)
[5] Climate Change Benchmarks: The Passive Pretenders
The Paris Alignment Paradox: Scoping Out Solutions
The Climate Data Conundrum

values and their understanding of risk. As noted above, some may decide to integrate certain red lines around their investment universe, relating to activities such as human rights violations, the fossil fuel value chain and corruption and others may take a less exclusionary approach. Some funds may wish to set engagement targets on certain companies with clear timeframes for response / improvement and subsequent action.

Crucially, before any mandate is given for funds to transition passive assets quickly there should be some consideration of what defines "passive" investing, or the pooling project risks its ability to achieve its goals.

Our research demonstrates that there is no such thing as “passive” Paris alignment. We believe that the only "passive" investment strategy is managed to a market cap weighted benchmark, where companies are organised according to a clear methodology. This belief is backed up by academic research[6], as well as our own lengthy experience in managing index-tracking funds.

Question 9: What capacity and expertise would the pools need to develop to take on management of legacy assets of the partner funds and when could this be delivered?

The Investment Association[7] has emphasised that for low-cost investment strategies, such as index-based/passive investments, it is generally more beneficial for pools to outsource portfolio management than to build the necessary internal resources.

The path to a net-zero economy remains necessarily uncertain in line with ongoing developments in climate science, policy, technology and data. Portfolio strategies aiming to align with the goals of the Paris agreement, or 'net zero', will require a similar level of flexibility and adaptability. In recent years there have been many attempts to design and deliver passive ESG / low carbon / climate aware / Paris aligned index tracking funds. Experience shows us that such indices often become defunct as the market develops and better, more sophisticated data becomes available. This can lead to additional costs as funds or pools need to transition to the latest available 'low carbon' or 'Paris aligned' index.

The sources of difference occur due to different data inputs, screening criteria or portfolio construction methodologies and can lead to considerable levels of risk

[6] Advisers by Another Name by Paul G. Mahoney, Adriana Robertson :: SSRN

[7] Source: IA response to the MHCLG consultation, LGPS: Next steps on investments.

(represented as tracking error) between different types of PAB or CTB and between the new indices and their parent benchmarks[8].

There are many subjective decisions required when building any ESG-related, climate aware or Paris aligned benchmark / index tracking fund. Those decisions should be made by a specialist portfolio manager who takes accountability for the investment outcome and ongoing management of the strategy.

The resources, experience and expertise required to manage a broad range of sustainability concerns, including climate risk, and meet increasing regulatory requirements in this area should not be underestimated.

Question 11: What scope is there to increase collaboration between pools, including the sharing of specialisms or specific local expertise? Are there any barriers to such collaboration?

As described above, the success of the pooling project was hampered by not considering sustainable investment in the early stages. This has led to a lack of unity on certain key issues such as net zero policy and created problems for pools in aligning sustainable investment strategies and making available appropriate investment vehicles that meet the needs of their diverse partner funds.

A more optimal differentiating feature between pools and alliances might be according to sustainable investment beliefs, such that funds can find the right alignment for their investment strategies.

For example, funds that have strong investment beliefs around net zero investment strategy and the management of financially material climate and nature-related risks may want to co-invest alongside funds with similar beliefs and appropriate strategies.

Question 24: Do you agree with the proposal to require pension committee members to have appropriate knowledge and understanding?

Our research on the management of climate related investment risk in the LGPS shows that political influences and high committee turnover can lead to different interpretations of the duties of the pensions committee and what constitutes 'fiduciary duty' in the context of sustainable investing. Given the amount of regulatory focus on sustainable investing, effective stewardship of assets and management of climate risk, we believe these areas should be prioritised in any member training or education program. Further, pools and funds should look to more academic training on climate risk to avoid

[8] Please refer to our research paper where we discuss this topic in detail, alongside other papers – see note 5 above.

any inherent biases or lack of expertise in financial services and consultancy firms.

Question 29: Do you agree that pools should report consistently and with greater transparency including on performance and costs? What metrics do you think would be beneficial to include in this reporting?

Reporting that focuses on net savings does not indicate delivery of value for money. Cost savings do not account for more sophisticated or tailored investment approaches, access to less liquid assets or increased focus on sustainability.

We support efforts to ensure the provision of transparent and comprehensive investment performance data. This should be provided relative to the relevant index, agreed during the procurement process and both net of fee and gross of fee data should be shown.

We reiterate that comparisons to 'Paris aligned' indices in place of market cap indices are problematic due to the active nature of index construction and considerable divergence in climate index risk and return outcomes.

We refer to our response to the government's consultation on the management and reporting of climate risk[9], where we highlight comparisons across funds as problematic.

[9] SAM Response to LGPS Consultation on Climate Reporting_FinalSubmission (11).pdf

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