



Department for
Communities and
Local Government

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

Consultation



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About this consultation

This consultation document and consultation process have been planned to adhere to the Consultation Principles issued by the Cabinet Office.

Representative groups are asked to give a summary of the people and organisations they represent, and where relevant who else they have consulted in reaching their conclusions when they respond.

Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000 (FOIA), the Data Protection Act 1998 (DPA) and the Environmental Information Regulations 2004.

If you want the information that you provide to be treated as confidential, please be aware that, under the FOIA, there is a statutory Code of Practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, of itself, be regarded as binding on the Department.

The Department for Communities and Local Government will process your personal data in accordance with DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Individual responses will not be acknowledged unless specifically requested.

Your opinions are valuable to us. Thank you for taking the time to read this document and respond.

Are you satisfied that this consultation has followed the Consultation Principles? If not or you have any other observations about how we can improve the process please contact DCLG Consultation Co-ordinator.

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or by e-mail to: consultationcoordinator@communities.gsi.gov.uk

The consultation process and how to respond

Scope of the consultation

Topic of this consultation:	<p>This consultation proposes to revoke and replace the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 with the draft regulations described in this paper. There are two main areas of reform:</p> <ol style="list-style-type: none"> 1. A package of reforms that propose to remove some of the existing prescribed means of securing a diversified investment strategy and instead place the onus on authorities to determine the balance of their investments and take account of risk. 2. The introduction of safeguards to ensure that the more flexible legislation proposed is used appropriately and that the guidance on pooling assets is adhered to. This includes a suggested power to allow the Secretary of State to intervene in the investment function of an administering authority when necessary.
Scope of this consultation:	<p>Views are sought on:</p> <ol style="list-style-type: none"> 1. Whether the proposed revisions to the investment regulations will give authorities the flexibility to determine a suitable investment strategy that appropriately takes account of risk. 2. Whether the proposals to introduce the power of intervention as a safeguard will enable the Secretary of State to intervene, when appropriate, to ensure that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.
Geographical scope:	<p>This consultation applies to England and Wales.</p>
Impact Assessment:	<p>The proposed interventions affect the investment of assets by local government pension scheme administering authorities. These authorities are all public sector organisations, so no impact assessment is required.</p>

Basic Information

To:	The consultation is aimed at all parties with an interest in the Local Government Pension Scheme (the Scheme) and in particular those listed on the Government's website: https://www.gov.uk/government/publications/local-government-pension-scheme-regulations-information-on-who-should-be-consulted
Body/bodies responsible for the consultation:	Secretary of State, Department for Communities and Local Government. The consultation will be administered by the Workforce, Pay and Pensions Division.
Duration:	25 November 2015 to 19 February 2016
Enquiries:	Enquires should be sent to Victoria Edwards. Please email LGPSReform@communities.gsi.gov.uk or call 0303 444 4057.
How to respond:	Responses to this consultation should be submitted to LGPSReform@communities.gsi.gov.uk by 19 February 2016 . Electronic responses are preferred. However, you can also write to: LGPS Reform Department for Communities and Local Government 2/SE Quarter, Fry Building 2 Marsham Street London SW1P 4DF
Additional ways to become involved:	If you would like to discuss the proposals, please email LGPSReform@communities.gsi.gov.uk
After the consultation:	All consultation responses will be reviewed and analysed. A Government response will then be published within three months, and subject to the outcome of this consultation, the resulting regulations laid in Parliament.
Compatibility with the Consultation Principles:	This consultation has been drafted in accordance with the Consultation Principles.

Background

<p>Getting to this stage:</p>	<p>The proposals in this consultation are the culmination of work looking into Local Government Pension Scheme investments that began in early 2013. It has been developed in response to the May 2014 consultation, <i>Opportunities for collaboration, cost savings and efficiencies</i>, which considered whether savings might be delivered through collective investment and greater use of passive fund management. A copy of the consultation and the Government's response is available on the Government's website: https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies.</p> <p>The consultation responses called for a voluntary approach to reform, opposing the introduction of a single, national model of pooling. The Government has therefore invited authorities to develop their own proposals for pooling, subject to common criteria and guidance. The criteria for reform have been developed using the consultation responses and following a series of workshops and conversations with authorities and the fund management industry since the July Budget 2015.</p> <p>Some respondents to the May 2014 consultation also suggested that amendments were required to the investment regulations in order to facilitate greater investment in pooled vehicles. In addition, prior to that consultation, authorities and the fund management industry had called for wider reform. A small working group, whose participants are listed in Annex A, was established to look at whether the approach to risk management and diversification in the existing regulations was still appropriate. They recommended moving towards the "prudential person" approach that governs trust based pension schemes. The group also sought clarity as to whether certain types of investment were possible, such as the use of derivatives in risk management. The work of that group has informed the development of this consultation.</p> <p>In relaxing the regulatory framework for scheme investments, it is important to introduce safeguards to ensure that the less prescriptive approach is used appropriately. The July Budget 2015 announcement also indicated that measures should be introduced to ensure that those authorities who do not bring forward ambitious proposals for pooling, in keeping with the criteria, should be required to pool. This consultation therefore sets out how the Secretary of State might intervene to ensure that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.</p>
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<p>Previous engagement:</p>	<p>The proposed changes in this consultation are the result of a programme of engagement that began in summer 2013:</p> <ul style="list-style-type: none"> • Round table event, 16 May 2013. Representatives of administering authorities, employers, trade unions, the actuarial profession and academia discussed the potential for increased cooperation within the Scheme. • A call for evidence, run with the Local Government Association, June to September 2013. This gave anyone with an interest in the Scheme the opportunity to inform the Government's thinking on potential structural reform. The results were shared with the Shadow Scheme Advisory Board, which provided the Minister for Local Government with their analysis of the responses. • Consultation, <i>Opportunities for collaboration, cost savings and efficiencies</i>, May to June 2014. The consultation set out how savings of £470-660m a year could be achieved by collective investment and greater use of passive fund management. It also sought views as to how these reforms might best be implemented. The Government's response is available online: https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies. • Informal engagement, July to November, 2015. Since the July Budget 2015 announcement, officials have attended over 25 workshops and bi-lateral meetings with administering authorities and the fund management industry. These discussions have been used to develop the criteria for reform and inform how the proposed power of the Secretary of State to intervene might work. <p>In addition, the Investment Regulation Review Group was formed in 2012 to consider potential amendments to the investment regulations. The group included representatives from administering authorities, actuarial firms, pension lawyers and the fund management industry. An initial proposal for reform was prepared that has also informed the development of the draft regulations that are the subject of this consultation.</p>
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Introduction and Background

Introduction

1.1 In May 2014 the Government published a consultation which set out how savings of up to £660m a year might be achieved through greater use of passive management and pooled investment. Investing collectively can help authorities to drive down costs and access the benefits of scale, and also enables them to develop the capacity and capability to invest more cost effectively in illiquid asset classes such as infrastructure. The Government has therefore invited authorities to develop ambitious proposals for pooling assets that meet published criteria. More information about the criteria and process of reform is available on the Government's website:

<https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance>.

1.2 This consultation complements that invitation, recognising that the existing regulations place restrictions on certain investments that may constrain authorities considering how best to pool their assets. It therefore proposes to move to a prudential approach to securing a diversified investment strategy that appropriately takes account of risk. In so doing, and to ensure that authorities take advantage of the benefits of scale, the Government proposes to introduce a power to allow the Secretary of State to intervene to ensure that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.

1.3 This paper sets out the purpose and rationale of the suggested amendments to the investment regulations, and seeks views as to whether the proposed approach would best deliver those stated aims.

Background

1.4 With assets of £178bn at its last valuation on 31 March 2013, the Local Government Pension Scheme is one of the largest funded pension schemes in Europe. Several thousand employers participate in the Scheme, which has a total of 4.68 million active, deferred and pensioner members.¹ The Department for Communities and Local Government is responsible for the regulatory framework governing the Scheme in England and Wales.

1.5 The Scheme is managed through 90 administering authorities which broadly correspond to the county councils following the 1974 local government reorganisation as well as each of the 33 London boroughs. In most cases, the administering authorities are upper tier local authorities such as county or unitary councils, but there are also some authorities established specifically to manage their pension liabilities, for example the London Pension Fund Authority and the Environment Agency Pension Fund. The

¹ Scheme asset value and membership figures taken from Department for Communities and Local Government statistical data set - Local government pension scheme funds summary data: 2012 to 2013 <https://www.gov.uk/government/statistical-data-sets/local-government-pension-scheme-funds-summary-data-2012-to-2013>

administering authorities have individual governance and working arrangements. Each has its own funding level, cash-flow and balance of active, deferred and pensioner members. Authorities take these circumstances into account when preparing their investment strategies, which are normally agreed by the councillors on each authority's pension committee. The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 set the legal framework for the development of these investment strategies and the investments carried out by administering authorities. This consultation proposes that the Government revokes and replaces those regulations.

1.6 Under the Public Service Pensions Act 2013, there is a requirement for a national scheme advisory board, as well as a local board for each of the 90 funds. In 2013, Scheme employers and the trade unions established a shadow board, which has been considering a number of issues connected with the Scheme, including its efficient management and administration. Appointments have now been made to the national scheme advisory board and the Chair is expected to be appointed shortly.

Getting to this stage

2.1 The consultation is formed of two main proposals:

1. A package of reforms that propose to remove some the existing prescribed means of securing a diversified investment strategy and instead place the onus on authorities to determine the balance of their investments and take account of risk. The changes proposed would move towards the “prudent person” approach to investment that applies to trust based pension schemes.
2. The introduction of safeguards to ensure that the more flexible legislation proposed is used appropriately, and that the guidance on pooling assets is adhered to, including a power to allow the Secretary of State to intervene in the investment function of an administering authority when necessary.

Pooling assets to deliver the benefits of scale

2.2 The proposals set out in this consultation are the culmination of work carried out over the last two and a half years to explore how to reform the way the Scheme makes its investments in order to achieve the benefits of scale and drive efficiencies.

2.3 In summer 2013, the coalition government launched a call for evidence to explore how the Scheme might be made more sustainable and affordable in the long term. 133 responses were received, many of which took the opportunity to discuss whether collective investment and greater collaboration might deliver savings for the Scheme.

2.4 Following the call for evidence, the Minister for the Cabinet Office and Minister for Local Government commissioned a cost-benefits analysis from Hymans Robertson on a range of proposals. Hymans Robertson’s report explored three areas:

- **The cost of investment:** Many of the costs associated with investment are not transparent and so difficult to capture. The costs of managing and administering the Scheme were reported as being £536 million in 2012-13.² However, Hymans Robertson found that the actual cost was likely to be rather higher; with investment costs alone estimated as in excess of £790 million a year.³
- **Approaches to collaboration:** Hymans Robertson was asked to examine the costs and benefits of three options for reform: merging the authorities into 5-10 funds, creating 5-10 collective investment vehicles, or establishing just 1-2 collective investment vehicles. They found that the net present value of savings over ten years was highest with a small number of vehicles, while merging funds offered the lowest benefit.⁴

² Local government pension scheme funds summary data: 2012 to 2013

³ Department for Communities and Local Government: Local Government Pension Scheme structure analysis, Hymans Robertson pp. 10-11. <https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies>

⁴ Hymans Robertson, p.6

- **The aggregate performance of the scheme:** The report found that the Scheme as a whole had been achieving the market rate of return in each of the main equity markets over the ten years to March 2013. If the Scheme's investments in bonds and equities had been managed passively instead of actively, authorities could have saved at least £230m a year in management fees without affecting overall investment returns.⁵

2.5 Drawing on the Hymans Robertson report and the call for evidence, the coalition government published a consultation in May 2014 entitled *Opportunities for collaboration, cost savings and efficiencies*. This set out how the Scheme could save up to £660m a year by using collective investment vehicles and making greater use of passive management for listed assets like bonds and equities. The consultation sought views on these proposals, and how they might be most effectively implemented. Respondents were broadly in favour of pooling assets, but felt that any reform should be voluntary and led by administering authorities. While many recognised a role for passive management in an investment strategy, most also felt that some active management should be retained.

2.6 At the July Budget 2015, Ministers having reflected on the consultation responses, the Chancellor announced the Government's intention to invite administering authorities to bring forward proposals for pooling local government pension scheme investments. Authorities' proposals would be assessed against published criteria, designed to encourage ambition in the pursuit of efficiencies and the benefits of scale. These criteria have now been published and are available online at <https://www.gov.uk/government/publications/local-government-pension-scheme-investment-reform-criteria-and-guidance>.

Updating the investment regulations

2.7 When considering the implications of creating asset pools amongst authorities, some respondents to the May 2014 consultation took the opportunity to call for a review of the existing investment regulations. At their introduction in 2009, the regulations sought to ensure that authorities established a balanced and diversified portfolio by placing restrictions on the proportion of their assets that could be invested in different vehicles. For example, deposits with a single bank, institution or person, (other than the National Savings Bank), were restricted to 10% of an authority's assets. These restrictions have been kept under regular review and have been subject to change following representations from the investment sector and pension fund authorities.

2.8 Some respondents to the consultation suggested that the current limits on investments would prevent authorities from making meaningful allocations to a collective investment vehicle, one of the leading options for asset pooling, as the allocation to particular types of vehicle is capped at 35%. Participants in the London Boroughs' collective investment vehicle and the collaboration between the London Pension Fund Authority and Lancashire County Council also wrote to the Department encouraging reform in this area.

⁵ Hymans Robertson, p.12

2.9 While the proposals for collective investment in the May 2014 consultation prompted encouragement to review the investment regulations, the idea of reform was not new. In 2012, following representations from the investment sector, the Government formed a small working group to revisit and examine the investment regulations with input from actuaries, fund managers and administering authorities. This group, whose membership is set out in Annex A, recommended that a more permissive approach should be taken to the legislative framework, similar to the “prudent person” model that applies to trust based pension schemes. This approach places the onus on the pension fund to determine a suitable balance of investments to meet its liabilities, which are clearly articulated in an investment strategy. The group also felt that the existing regulations introduced uncertainty for some authorities as to what constituted a permitted investment, as some asset classes were explicitly referenced but others were not. In particular, concern has been expressed as to whether or not pension fund authorities are permitted to invest in vehicles such as derivatives, hedge funds and forward currency contracts.

2.10 The proposals in this consultation paper therefore seek to address these issues, placing the onus on authorities to determine a diversified investment strategy that appropriately takes risk into account.

2.11 However, in relaxing the regulatory framework for scheme investments, it is also important to introduce safeguards to ensure that the less prescriptive approach proposed is used appropriately. Similarly, the July Budget 2015 announcement stated that draft regulations would be introduced to require an authority to pool its investments if it did not bring forward ambitious proposals that met the Government’s criteria. This consultation therefore sets out how the Secretary of State might intervene to ensure that authorities take advantage of the benefits of scale offered by pooling and deliver investment strategies that adhere to regulation and guidance.

Response to the Law Commission’s Review of Fiduciary Duty

2.12 The Kay Review on Fiduciary Duty published its final report in July 2012. In addition to making a number of recommendations to address the excessive focus on short-term performance in equity investment markets, it recommended that the Government ask the Law Commission to review the fiduciary duties of investment intermediaries amid concerns that these common law duties were being interpreted by some pension schemes as a requirement to focus solely on short-term financial returns.

2.13 In their report, published in July 2014, the Law Commission called on the Department to review:

- Whether the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 should transpose article 18(1) of the Institutions for Occupational Retirement Provision (IORP) Directive, and
- Those aspects of Regulation 9 of the 2009 Regulations which require investment managers to be appointed on a short-term basis and reviewed every three months.

2.14 These recommendations were supported by the Government's progress report on the implementation of the Kay Review published in October 2014 by the Department for Business Innovation and Skills.

2.15 Article 18(1) of the IORP Directive requires assets to be invested in the best interests of members and beneficiaries and, in the event of a conflict of interest, in the sole interests of members and beneficiaries.

2.16 Regulation 4 of The Occupational Pension Schemes (Investment) Regulations 2005 (SI 2005 No 3378) transposed Article 18(1):

"4. (1) The trustees of a trust scheme must exercise their powers of investment, and any fund manager to whom any discretion has been delegated under section 34 of the 1995 Act (power of investment and delegation) must exercise the discretion, in accordance with the following provisions of this regulation

(2) The assets must be invested:

- (a) In the best interests of members and beneficiaries; and
- (b) In the case of a potential conflict of interest, in the sole interest of members and beneficiaries."

2.17 The Local Government Pension Scheme is a statutory scheme made under section 1 of the Public Service Pensions Act 2013 and previously under The Superannuation Act 1972. It is not subject to trust law and those responsible for making investment decisions in the Scheme are not therefore required to comply with Regulation 4 of the 2005 Regulations.

2.18 However, this does nothing to change the general legal principles governing the administration of Scheme investments and how those responsible for such decisions should exercise their duties and powers under the Scheme's investment regulations.

2.19 In a circular issued by the then Department of the Environment in 1983 (No 24), the Secretary of State took the view that administering authorities should pay due regard to the principle contained in the case of *Roberts v Hopwood* [1925] A.C. 578 p. 595:

"A body charged with the administration for definite purposes of funds contributed in whole or in part by persons other than members of that body owes, in my view, a duty to those latter persons to conduct that administration in a fairly business-like manner with reasonable care, skill and caution, and with a due and alert regard to the interest of those contributors who are not members of the body. Towards these latter persons, the body stands somewhat in the position of trustees or managers of the property of others."

2.20 Those in local government responsible for making investment decisions must also act in accordance with ordinary public law principles, in particular, the ordinary public law principles of reasonableness. They risk challenge if a decision they make is so unreasonable that no reasonable person acting reasonably could have made it.

2.21 Having considered fully the recommendation made by the Kay Review and supported by both the Law Commission and the Government, Ministers are satisfied that the Scheme is consistent with the national legislative framework governing the duties placed on those responsible for making investment decisions. The position at common law

is also indistinguishable from that produced by the 2005 Regulations applicable in respect of trust-based schemes.

2.22 We do, however, propose to remove the requirement for the performance of investment managers to be reviewed once every three months from the regulations.

Proposal 1: Adopting a local approach to investment

Deregulating and adopting a local approach to investment

3.1 In developing these draft regulations, the Government has sought, where appropriate, to deregulate and simplify the regulations that have governed the management and investment of funds since 2009. Some of the existing provisions have not been carried forward into the draft 2016 Regulations in the expectation that they would be effectively maintained by general law provisions and so specific regulation is no longer needed. For example, those making investment decisions are still required to act prudently, and there remains a statutory requirement to take and act on proper advice. Some of the provisions in the 2009 Regulations which have not been carried forward on this basis include:

- Stock lending arrangements under Regulation 3(8) and (9) of the 2009 regulations. The view is taken that the definition of “investment” in draft Regulation 3 is sufficient given that a stock lending arrangement can only be used if it falls within the ordinary meaning of an “investment”.
- Regulation 8(5) of the 2009 regulations ensures that funds are managed by an adequate number of investment managers and that, where there is more than one investment manager, the value of the fund money managed by them is not disproportionate. Here, the view is taken that administering authorities should be responsible for managing their own affairs and making decisions of this kind based on prudent and proper advice.
- There are many provisions in the 2009 Regulations which impose conditions on the choice and terms of appointments of investment managers. Since the activities of investment managers are governed by the contracts under which they are appointed, the view is taken that making similar provision in the 2016 Regulations would be unnecessary duplication. Examples include the requirement for investment managers to comply with an administering authority’s instructions and the power to terminate the appointment by not more than one month’s notice.
- Regulation 12(3) of the 2009 Regulations requires administering authorities to state the extent to which they comply with guidance given by the Secretary of State on the Myners principles for investment decision making. As part of the wider deregulation, the draft regulations make no provision to report against these principles, although authorities should still have regard to the guidance.

3.2 These examples of deregulation are for illustrative purposes only. It is not an exhaustive list of provisions which the Government proposes to remove. Consultees are asked to look carefully at the full extent of deregulation and comment on any particular case that raises concerns about the impact such an omission might have on the effective management and investment of funds.

Investment strategy statement

3.3 As part of this deregulation, the draft regulations also propose to remove the existing schedule of limitations on investments. Instead authorities will be expected to take a prudential approach, demonstrating that they have given consideration to the suitability of different types of investment, have ensured an appropriately diverse portfolio of assets and have ensured an appropriate approach to managing risk.

3.4 Key to this will be the investment strategy statement, which authorities will be required to prepare, having taken proper advice, and publish. The statement must cover:

- A requirement to use a wide variety of investments.
- The authority's assessment of the suitability of particular investments and types of investments.
- The authority's approach to risk, including how it will be measured and managed.
- The authority's approach to collaborative investment, including the use of collective investment vehicles and shared services.
- The authority's environmental, social and corporate governance policy.
- The authority's policy on the exercise of rights, including voting rights, attached to its investments.

Transitional arrangements

3.5 Draft regulation seven proposes to require authorities to publish an investment strategy statement no later than six months after the regulations come into force (this is currently drafted as 1 October 2016, in case the draft regulations come into effect on 1 April 2016). However, the draft regulations would also revoke the existing 2009 Regulations when they come into effect. Transitional arrangements are therefore required to ensure that an authority's investments and investment strategy are regulated between the draft regulations coming into effect and the publication of an authority's new investment strategy statement. The transitional arrangements proposed in draft regulation 12 would mean that the following regulations in the 2009 Regulations would remain in place until the authority publishes an investment strategy or six months lapses from the date that the regulations come into effect:

- 11 (investment policy and investment of pension fund money)
- 14 (restrictions on investments)
- 15 (requirements for increased limits)
- Schedule 1 (table of limits on investments)

Statement of Investment Principles

3.6 We do not propose to carry forward the existing requirement under regulation 12 of the 2009 Regulations to maintain a Statement of Investment Principles. However, the main elements, such as risk, diversification, corporate governance and suitability, will instead be carried forward as part of the reporting requirements of the new investment strategy

statement. Administering authorities will still be required to maintain their funding strategy statements under Regulation 58 of the 2013 regulations.

Non-financial factors

3.7 The Secretary of State has made clear that using pensions and procurement policies to pursue boycotts, divestments and sanctions against foreign nations and the UK defence industry are inappropriate, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government. The Secretary of State has said, “Divisive policies undermine good community relations, and harm the economic security of families by pushing up council tax. We need to challenge and prevent the politics of division.”

3.8 The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 already require administering authorities to publish and follow a statement of investment principles, which must comply with guidance issued by the Secretary of State. The draft replacement Regulations include provision for administering authorities to publish their policies on the extent to which environmental, social and corporate governance matters are taken into account in the selection, retention and realisation of investments. Guidance on how these policies should reflect foreign policy and related issues will be published ahead of the new Regulations coming into force. This will make clear to authorities that in formulating these policies their predominant concern should be the pursuit of a financial return on their investments, including over the longer term, and that, reflecting the position set out in the paragraph above, they should not pursue policies which run contrary to UK foreign policy.

Investment

3.9 A few definitions and some aspects of regulation 3, which describes what constitutes an investment for the purpose of these regulations, have been updated to take account of changing terminology and technical changes since the regulations were last issued in 2009. For example, the reference to the London International Financial Futures Exchange (LIFFE) has been removed as it now operates as a clearing house and so is covered by the approved stock exchange definition.

3.10 Some additional information has been included to make clear that certain investments, such as derivatives, may be used where appropriate. The Government expects that having considered the appropriateness of an investment in their investment strategy statement, authorities would only use derivatives as a means of managing risk, and so has not explicitly stated that this should be the case.

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

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

Proposal 2: Introducing a safeguard - Secretary of State power of intervention

Summary of the proposal

4.1 The first part of this consultation lifts some of the existing restrictions on administering authorities' investments in order to make it easier for them to pool their investments and access the benefits of scale. To ensure that this new flexibility is used appropriately, the consultation also proposes to introduce a power to intervene in the investment function of an administering authority if the Secretary of State believes that it has not had regard to guidance and regulations. The consultation sets out the evidence that the Secretary of State may draw on before deciding to intervene, and makes clear that any direction will need to be proportionate. The power proposed in this consultation is intended to allow the Secretary of State to act if best practice or regulation is being ignored, which will help to ensure that authorities continue to pursue more efficient means of investment.

4.2 The July Budget 2015 announcement set out the Government's intention to introduce "backstop" legislation to require those authorities who do not bring forward sufficiently ambitious plans to pool their investments. It also explained that authorities' proposals would need to meet common criteria, which have been published with draft guidance alongside this consultation. The draft power to intervene discussed in this paper could be used to address authorities that do not bring forward proposals for pooling their assets in line with the published criteria and guidance. The guidance will be kept under review, and will be revised as circumstances change and authorities' asset pools evolve.

4.3 The following sections set out the process for intervention described in draft regulation 8.

Determining to intervene

4.4 The draft regulations propose to give the Secretary of State the power to intervene in the investment function an administering authority, if the Secretary of State has determined that the administering authority has failed to have regard to the regulations governing their investments or guidance issued under draft regulation 7(1). In reaching that conclusion, the Secretary of State will consider the available evidence, which might include:

- Evidence that an administering authority is ignoring information on best practice, for example, by not responding to advice provided by the scheme advisory board to local pension boards.
- Evidence that an administering authority is not following the investment regulations or has not had regard to guidance published by the Secretary of State under draft Regulation 7 (1). For example, this might include failing to participate in one of the large asset pools described in the existing draft guidance, or proposing a pooling arrangement that does not adhere to the criteria and guidance.

- Evidence that an administering authority is carrying out another pension-related function poorly, such as an unsatisfactory report under section 13(4) of the Public Service Pensions Act 2013, or another periodic reporting mechanism. (Section 13(4) of the 2013 Act requires a person appointed by the Secretary of State to report on whether the actuarial valuation of a fund has been carried out in accordance with Scheme regulations, in a way that is consistent with other authorities' valuations, and so that employer contribution rates are set to ensure the solvency and long term cost efficiency of the fund.)

4.5 If the Secretary of State has some indication to suggest that intervention might be necessary, the draft regulations propose that he may order a further investigation to provide him with the analysis required to make a decision. If additional evidence is sought, draft regulation 8(5) would allow the Secretary of State to carry out such inquiries as he considers appropriate, including seeking advice from external experts if needed. In this circumstance, the administering authority would be obliged to provide any data that was deemed necessary to determine whether intervention is required. The authority would also be invited to participate in the review and would have the opportunity to present evidence in support of its existing or proposed investment strategy.

The process of intervention

4.6 If the Secretary of State is satisfied that an intervention is required, he would then need to determine the appropriate extent of intervention in the authority's investment function. The draft regulations propose to allow the Secretary of State to draw on external advice to determine what the specific intervention should be if necessary.

4.7 Draft regulation 8(2) describes the interventions that the Secretary of State may make. The power has been left intentionally broad to ensure that a tailored and measured course of action is applied, based on the circumstances of each case. For example, in some cases it may be appropriate to apply the intervention just to certain parts of an investment strategy, whereas in particularly concerning cases, more substantial action might be required. The proposed intervention might include, but is not limited to:

- Requiring an administering authority to develop a new investment strategy statement that follows guidance published under draft Regulation 7(1).
- Directing an administering authority to invest all or a portion of its assets in a particular way that more closely adheres to the criteria and guidance, for instance through a pooled vehicle.
- Requiring that the investment functions of the administering authority are exercised by the Secretary of State or his nominee.
- Directing the implementation of the investment strategy of the administering authority to be undertaken by another body.

4.8 The Secretary of State will write to the authority outlining the proposed intervention. As a minimum, this proposal will include:

- A detailed explanation of why the Secretary of State is intervening and the evidence used to arrive at their determination.

- A clear description of the proposed intervention and how it will be implemented and monitored.
- The timetable for the intervention, including the period of time until the intervention is formally reviewed.
- The circumstances under which the intervention might be lifted prior to review.

4.9 The authority will then be given time to consider the proposal and present its argument for any changes that it thinks should be made. If, at the end of that period an intervention is issued, any resulting costs, charges and expenses incurred in administering the fund would be met by the pension fund assets.

Review

4.10 As set out above, each intervention will be subject to a formal review period which will be set by the Secretary of State but may coincide with other cyclical events such as the preparation of an annual report or a triennial valuation. At the end of that period, progress will be assessed and the Secretary of State will decide whether to end, modify or maintain the current terms of the intervention, and will notify the authority of the outcome. The authority will also have the opportunity to make representations to the Secretary of State if it feels a different course of action should be followed. Throughout this period of intervention, the authority will be supported to improve its investment function, so that it is well placed to bring the intervention to an end at the first opportunity.

4.11 The Secretary of State's direction will include details about what is required of the authority in order to end the intervention, and how progress will be measured. Progress could, for example, be measured by creating a set of performance indicators to be monitored on an ongoing basis by Government officials, the local pension board, the scheme advisory board, or an independent body. A regime of regular formal reports to the Secretary of State could also be required.

4.12 The draft regulations also allow the Secretary of State to determine that sufficient improvement has been made to end the intervention before the review date. The administering authority may also make representations to the Secretary of State before that date, if it has clear evidence that the prescribed action is no longer appropriate.

Questions

5. Are there any other sources of evidence that the Secretary of State might draw on to establish whether an intervention is required?
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?
7. Does the proposed approach allow the Secretary of State sufficient flexibility to ensure that he is able to introduce a proportionate 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?

Summary of the draft regulations

(1) Citation, commencement and extent

This details the citation and scope of the draft regulations, and gives the date at which they will come into force.

(2) Interpretation

These provisions define terms used in the draft regulations with reference to legislation, and cite the legislation that gives administering authorities the powers that may be impacted by the draft regulations.

(3) Investment

This draft regulation defines what is considered an investment for the purposes of the regulations. This definition includes futures, options, derivatives, limited partnerships and some types of insurance contracts. It also defines who a person with whom a contract of insurance can be entered into is.

(4) Management of a pension fund

This draft regulation lists the monies that an administering authority must credit to its pension fund, including employer and employee contributions, interest, and investment capital and income. It also sets out the administering authority's responsibility to pay benefits entitled to members, and states that, except where prohibited by other regulations, costs of administering the fund can be paid by the fund.

(5) Restriction on power to borrow

This proposed regulation outlines the limited circumstances under which an administering authority can borrow money that the pension fund is liable to repay.

(6) Separate bank account

The draft regulation states that an administering authority must deposit all pension fund monies in a separate account, and lists those institutions that can act as a deposit taker. It also states that the deposit taker cannot use pension fund account to set-off any other account held by the administering authority or a connected party.

(7) Investment strategy statement

This draft regulation places an obligation on the administering authority to consult on and publish an investment strategy statement, which must be in accordance with guidance from the Secretary of State. The statement should demonstrate that investments will be suitably diversified, and it should outline the administering authority's maximum allocations for different asset classes, as well as their approach to risk and responsible investing.

In many respects, the investment strategy statement replaces the list of restrictions given in Schedule 1 of the 2009 Regulations and enables the criteria to be determined at local

level. Schedule 1 of the 2009 Regulations will remain in force until such time that the new investment strategy statements have to be published.

Provision is made for authorities to publish their policy on the extent to which environmental, social and corporate governance factors are taken into account in the selection, retention and realisation of investments.

Separate guidance will be issued by the Secretary of State that will clarify how the Government's recent announcement on boycotts, sanctions and disinvestment will be exercised.

(8) Directions by the Secretary of State

This provision would grant the Secretary of State the power to intervene in the investment function of an administering authority if he is satisfied that the authority is failing to have regard to regulation and guidance. He can also initiate inquiries to determine if an intervention is warranted, and must consult with the authority concerned. Once it is determined that an intervention is needed, the Secretary of State can intervene by directing the authority undertake a broad range of actions to remedy the situation.

(9) Investment managers

This draft regulation details how an administering authority must appoint external investment managers.

(10) Investments under section 11(1) of the Trustee Investments Act 1961

This draft regulation allows administering authorities to invest in Treasury-approved collective investment schemes.

(11) Consequential amendments

This proposed regulation lists the prior regulations that are amended by the draft amendments.

(12) Revocations and transitional provisions

The draft provision lists the regulations that would be revoked if the draft regulations come into effect. It also proposes transitional arrangements to ensure that the existing regulations governing the investment strategy remain in place until a new investment strategy statement is published by an authority under draft regulation seven. These transitional arrangements would apply for up to six months after the draft regulations came into effect.

Annex A: Members of the Investment Regulation Review Group

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Dawn Turner	Environment Agency Pension Fund
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