



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

Government response to the Consultation

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Department for Communities and Local Government  
Fry Building  
2 Marsham Street  
London  
SW1P 4DF  
Telephone: 030 3444 0000

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# Introduction

1. On 19 November 2015, the Department for Communities and Local Government published *Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009*, which set out proposals to bring forward a new set of regulations governing investments made by local government pension scheme administering authorities.
2. The consultation laid out three main areas of reform :
  - Removing some of the existing prescribed means of securing a diversified investment strategy and instead placing the onus on authorities to determine the balance of their investments and take account of risk.
  - The introduction of safeguards to ensure that the more flexible legislation proposed is used appropriately and that the guidance on pooling of assets is adhered to. This includes a suggested power to intervene in the investment function of an administering authority when necessary.
  - The introduction of statutory guidance to assist administering authorities prepare for the new Investment Strategy Statements, including specific guidance on the extent to which non-financial factors should be taken into account when making investment decisions and how these should reflect UK foreign policy.
3. The consultation closed on 19 February 2016. Further representations received up to 7 March have also been taken into account. A copy of the paper can be found at: <https://www.gov.uk/government/consultations/revoking-and-replacing-the-local-government-pension-scheme>
4. This document summarises the responses to the consultation and sets out the next steps on implementing the new investment regulations and associated guidance.

# Overview of the responses received

5. As at 7 March 2016, the consultation had received 23,516 responses. Not all respondents answered every question and in a number of cases responses did not fit neatly to particular questions and required some interpretation. Respondents expressed a wide range of views, from strong opposition to the proposed intervention power to broad support for the proposal to deregulate the investment function and provide additional flexibility to administering authorities.
6. 98% of the 23,516 responses were from members of the public, primarily in response to the proposal that in formulating their policy on the extent to which non-financial factors should be taken into account when making investment decisions, administering authorities should not pursue policies that run contrary to UK foreign policy. A breakdown of respondents is set out in the table below. The group 'Other' includes responses that did not easily fit into one of the other categories.

<b>Origin of response</b>	<b>Total</b>
Councils/Administering Authorities	62
Trade unions	278
Representative bodies	2
Religious groups	6
Asset managers	7
Pension lawyers	6
Consulting actuaries	3
Investment consultants	3
Members of the public	23,131
Other	18
<b>Total</b>	<b>23,516</b>

After careful consideration of all responses to the consultation, the Government has decided to make a number of changes to the draft regulations before they are introduced. These are summarised in Parts A to C below.

## Part A – Responses to Questions 1 to 8

7. The consultation sought responses to eight questions about the draft regulations.

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

### Comments

In total, 85 responses addressed this question. 55 (65%) indicated that the draft regulations would achieve the policy objective and a further 28 (33%) gave broad support to the proposal. 2 respondents disagreed. One argued that IORP Directive

41/2003 should be applied instead and the other that the intervention proposal was inconsistent with devolving power to local government.

**Government response**

The majority of those who responded to this question agreed that the draft regulations achieve the policy intention of further deregulating the investment functions of administering authorities.

The aim of IORP Directive 41/2003 was, in part, to increase security for pension scheme members and to safeguard pension assets from employers in the event of bankruptcy or insolvency. It was transposed into domestic legislation by the Government in 2005. Funded statutory schemes like the local government pension scheme in England and Wales were exempted from most of the key provisions of the Directive because the benefits are guaranteed by a public body. More specifically the local government pension scheme already had provisions to separate the assets of the scheme from those of the sponsoring employer. The Government therefore remains of the view that the scheme is consistent with the national legislative framework governing the duties placed on those responsible for making investment decisions and that there is no need to introduce any further legislation to comply with Directive 41/2003.

We do not agree that the proposed intervention power would be inconsistent with devolving power to local government. Administering authorities will continue to be responsible for setting their policy on asset allocation, risk and diversity. However, given the very large sums of public money at stake, we believe that it is entirely appropriate for the Secretary of State to be able to intervene where concerns have been raised, having taken account of all available evidence.

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

**Comments**

Of the 61 responses, 32 (52%) agreed that there were no specific issues to reinstate. Of the 29 who disagreed (48%), a majority of 18 said that reporting against the Myners investment principles as currently required under Regulation 12(3) of the Local Government Pension Scheme (Management and Investment of Funds ) Regulations 2009 should be carried forward into the new regulations.

**Government response**

In view of the mixed response, we propose that administering authorities should be left to decide for themselves whether to report compliance (or otherwise) against the Myners' investment principles as part of their investment strategy statement or annual pension fund report.

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

**Comments**

29 of the 64 responses to this question (45%) agreed that 6 months was an appropriate transitional period. Of the 35 that disagreed (55%), 25 suggested a 12 month period; 9 favoured a 9 month period and 1 respondent simply wanted a longer period without stipulating how long.

### **Government response**

On balance, we consider that a longer transitional period up to 31 March 2017 would be more appropriate and would afford more time for administering authorities to prepare and publish their Investment Strategy Statements during a particularly busy period implementing the new pooling arrangements.

### **Question 4: Should the regulations be explicit that derivatives should only be used as a risk management tool?**

#### **Comments**

All 72 responses to this question objected to the proposal that derivatives should only be used as a risk management tool. Opinion was divided between those who argued that the regulations should allow derivatives to be used for both risk management and efficient portfolio management (56%) and those who considered that no definition was necessary and that administering authorities should be given the flexibility to make their own decisions within their prudential framework.

### **Government response**

Having considered the views expressed by the majority of respondents, we propose that administering authorities should be given the flexibility, within their prudential framework, to make their own decisions on how to use derivative instruments within their overall investment portfolio. However, further clarification on the use of derivative instruments will be provided in the guidance to be published under draft regulation 7(1).

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

#### **Comments**

Of the 67 responses, 19 (28%) considered that no additional sources of evidence were required. 8 responses suggested that an independent expert's report should be obtained, 4 said that evidence that "proper advice" had been taken should be provided, and 4 suggested that the key performance indicators to be published by the scheme advisory board should be taken into account.

### **Government response**

Further clarification on the evidence that the Secretary of State might draw on to establish whether an intervention is required will be provided in the guidance to be published under draft Regulation 7(1).

**Question 6: Does the intervention power 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?**

**Comments**

Only 9 out of the 58 responses that addressed this point (16%) supported the view that the draft regulations allowed sufficient scope and time. Of the remaining 49 responses, 30 (52%) made general comments opposing the proposal to introduce an intervention power. 19 respondents (32%) suggested a range of alternative time periods including:

- A reasonable period (7)
- 3 months (5)
- 60 days (3)
- 6 months (2)
- 2 months (1)
- 180 days (1)

**Government response**

The period allowed for consultation before the Secretary of State makes a decision to issue a direction will vary depending on the complexity and the extent of intervention in each particular case. It would not therefore be appropriate to prescribe a set period in the regulations. Administering authorities will be given a reasonable period to present evidence depending on the circumstances of each case.

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

**Comments**

15 out of the 64 responses to this question (24%) supported the view that the draft regulations allowed the Secretary of State sufficient flexibility to make proportionate interventions. Of the 49 that disagreed:

- 22 (34%) considered that the proposed intervention power is too broad;
- 13 (20%) thought that the power should only apply to the pooling arrangements;
- 10 (16%) thought that the power was inconsistent with the proposed Investment Strategy Statements and Funding Strategy Statements; and
- 4 (6%) considered that the Secretary of State was not the appropriate person to intervene in investment matters.

**Government response**

A significant number of respondents considered that the proposed intervention power is too broad. However, we remain of the view that appropriate checks and balances are required in a framework that will significantly deregulate administering authorities' investment functions, particularly given the very large sums of public money involved.

**Question 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, etc?**

### **Comments**

16 out of the 66 responses to this question (24%) agreed that the proposals would meet the policy objectives. Of the remaining 50 responses, 30 (45%) objected to the proposals in broad terms, 18 (27%) said that more clarification in guidance was necessary and 2 (4%) suggested that the intervention power should only be considered on the recommendation of the scheme advisory board.

### **Government response**

The concerns expressed about the power being too broad is addressed in the response to Question 7 above. We have considered further the role of the scheme advisory board in the use of the intervention power. On balance, given that draft regulation 7(4)(b) already includes provision for a report from the board to be taken into account by the Secretary of State before a direction is issued, we have concluded that there would be no advantage in making further changes.

## **Part B – Comments on specific draft regulations**

### **Regulation 3**

#### **Comments**

Several respondents suggested that draft Regulation 3 is inconsistent with the overall deregulatory approach to the new regulations and does not enable administering authorities to exercise their own investment strategy and asset allocation in accordance with the proposed Investment Strategy Statement.

#### **Government response**

Draft regulation 3 merely clarifies the way in which certain investment terms are to be interpreted for the purposes of the regulations, so that administering authorities and others may be clear about their scope. We do not consider that this provision is inconsistent with the overall deregulatory approach of the regulations or an administering authority's capacity to decide their own investment strategy and asset allocation policies.

#### **Comments**

Several respondents suggested that the reference to derivatives in draft Regulation 3(3), although welcome, still allows scope for uncertainty about the extent to which administering authorities may invest in derivatives. Another respondent said that derivatives should be defined in such a way to enable authorities to invest in foreign exchange transactions, including spot foreign exchange transactions, repos and stock lending, irrespective of how they are traded.

#### **Government response**

Under the proposed regulations, administering authorities will be required to formulate their funding and investment strategies within the context of a prudential framework and having taken proper advice. Prescribing the types of investments, such as derivatives, in the new regulations would therefore run counter to the new deregulatory approach. Further clarification will be provided in the guidance to be published under draft regulation 7(1).

## **Regulation 4**

### **Comments**

The Local Government Association sought clarification on whether Regulation 4 in particular, covers all funds within the scheme, for example, the Environment Agency's closed fund.

### **Government response**

We believe that it is clear from the definition of "authority" in draft Regulation 2 and the link to the list of administering authorities in Part 1 of Schedule 3 to the 2013 Regulations, that draft Regulation 4 would cover all the funds administered by those bodies.

## **Regulation 7**

### **Comments**

One respondent suggested that the words "social, environmental or corporate governance considerations" where they appear in draft Regulation 7(2)(e), should be replaced with "social, environmental and corporate governance considerations" to ensure that the three individual elements are not seen as options.

### **Government response**

The view is taken that draft regulation 7(2)(e) as drafted, would require administering authorities to formulate their policy under all three elements of social, environmental and corporate governance.

### **Comments**

One respondent suggested that draft Regulation 7 should be extended to require administering authorities to state their policy on their compliance with national and global standards of good stewardship.

### **Government response**

We will shortly be reviewing the regulations that require administering authorities to publish a governance compliance statement, which could include a reference to standards of good stewardship, and will consider this comment in that context.

### **Comments**

A number of respondents considered that draft Regulation 7(2)(e) could be more comprehensive and include political or geographical considerations that might be taken into account.

### **Government response**

Provided that the guidance to be published under draft Regulation 7(1) is complied with, there is nothing in draft regulation 7(2)(e) to prevent an administering authority from taking any non-financial consideration into account provided that it is made in the best long term interests of scheme beneficiaries, and does not represent any significant risk to the health of the fund.

### **Comments**

One respondent suggested that the draft regulation should be extended to ensure that administering authorities, as shareholders, must adopt an active policy regarding engagement.

### **Government response**

As institutional shareholders, administering authorities are encouraged to adopt policies of engagement that protect their investments and ensure that the companies in which they invest comply with the law, accounting standards and recognised standards of corporate governance. The intention of the new regulations is to give administering authorities flexibility in the way they engage but to require them, for the first time, to publish their policy in a transparent and open manner.

### **Comments**

One respondent proposed that draft regulation 7(2)(a) should be amended to read from “a requirement to invest fund money in a wide variety of investments” to “a requirement to consider investing in a wide variety of instruments.” It was suggested that too much diversification could result in increased fund management costs.

### **Government response**

Introducing such an amendment would run the risk of leaving administering authorities with the option of not diversifying their investments. The extent to which investments are diversified and the impact that this has on management costs will be matters for administering authorities to consider when formulating their new Investment Strategy Statement.

### **Comments**

One respondent suggested that draft Regulation 7(2)(e) should be amended to require administering authorities to differentiate between the financial and non-financial implications of their policy on how social, environmental and corporate governance factors are taken into account when making investment decisions.

### **Government response**

This point will be clarified in the guidance to be published under draft Regulation 7(1)

## **Regulation 8**

### **Comments**

One respondent suggested that the word “reasonably” should be inserted before the word “satisfied” where it appears in draft Regulation 8(1).

### **Government response**

The Secretary of State would be required under general public law principles to act reasonably in deciding whether an administering authority is failing to act in accordance with the guidance to be published under draft Regulation 7(1).

## **Part C – Other matters**

In addition to the responses summarised at Parts A and B above, over 23,000 members of the public objected to the consultation proposals on the grounds that they:-

- Undermined the independence of administering authorities to act in scheme members' interests;
- Prevented administering authorities from practising ethical investment; and
- Undermined the Government's commitment to transfer power to local government.

### **The independence of administering authorities to act in scheme members' interests**

#### **Comments**

Over 23,000 members of the public disagreed with the proposal to grant the Secretary of State the power to intervene in local authorities' investment decisions. In their view, the proposal undermined the rights and choices of pension fund members and the independence of financial decision making to act in members' interests.

#### **Government response**

In relaxing the regulatory framework for scheme investments, administering authorities will be expected to make their investment decisions within a prudential framework with less central prescription. It is important therefore that the regulations include a safeguard to ensure that this less prescriptive approach is used appropriately and in the best long-term interests of scheme beneficiaries and taxpayers.

Under draft Regulation 7, decisions about risk management, investment strategy and asset allocation will remain the responsibility of individual administering authorities. However, where there is evidence to suggest that an authority is failing to act in accordance with the regulations and guidance, it may be appropriate for the Secretary of State to consider intervention, but only where this is justified and where the relevant parties have been consulted. Draft Regulation 8 includes a number of safeguards, including full consultation with the relevant authority, to ensure that the proposed power is used appropriately, proportionately and only where justified by the evidence.

The view is therefore taken that the proposal to grant the Secretary of State a power of intervention would not interfere with the duty of elected members under general public law principles to make investment decisions in the best long-term interest of scheme beneficiaries and taxpayers.

### **The right of administering authorities to practise ethical investment**

#### **Comments**

A significant majority of respondents claim that local authorities across the UK have adopted fair trade principles or excluded fossil fuel, tobacco and arms companies from

their investment portfolios in response to local concerns. These are considered to be important ethical stances that reflect the values and opinions of local communities who want to ensure that local government is not supporting companies with proven records of doing harm to the environment, health and human rights.

### **Government response**

On the evidence publicly available, it is not clear to what extent administering authorities are currently adopting fair trade principles or excluding certain investments based on non-financial considerations. There is nothing in the proposed regulations that would prevent an administering authority from taking such factors into account when making investment decisions, provided that they comply with the guidance published under draft regulation 7(1). The regulations will also ensure that information about non-financial considerations will be in the public domain and subject to scrutiny.

The majority of respondents also expressed concern about the way in which the policy on compliance with UK foreign policy is to be taken forward in the guidance to be published under draft Regulation 7(1). However, the Government remains committed to the policy set out in November's consultation paper that administering authorities should not pursue investment policies against foreign nations and UK defence industries, other than where formal legal sanctions, embargoes and restrictions have been put in place by the Government.

In making investment decisions, the Government is clear that administering authorities must continue to act responsibly and to make investment decisions that secure long term financial returns and are taken in the best interests of funding members' benefits.

### **The Government's commitment to transfer power to local government**

#### **Comments**

A significant majority of respondents claimed that granting the Secretary of State a power of intervention on investment functions would undermine the UK Government's stated commitment to transfer power to local government and would represent a serious attack on local democracy.

### **Government response**

This is not the case. One of the main aims of the proposal is to deregulate and transfer investment decisions and their consideration more fully to administering authorities within a new prudential framework. Administering authorities will continue to be responsible for setting their policy on asset allocation, risk and diversity. However, given the very large sums of public money at stake, we believe that it is entirely appropriate for the Secretary of State to be able to intervene where concerns have been raised, having taken account of all available evidence.

In the case of the new pooling arrangements, the view is taken that it is appropriate for the Secretary of State to be able to intervene in circumstances where administering authorities are failing to comply with the criteria and guidance on the new pooling arrangements. This power would only be used where there is clear evidence that an authority is failing to comply with regulations, guidance or best practice.

