Pension Fund Committee

8 December 2016

Investment Regulations

Durham County Council

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Purpose of the Report

1. To inform Members of the publication of the Local Government Pension Scheme (LGPS) (Management and Investment of Funds) Regulations 2016, associated guidance relating to setting an investment strategy unde these regulations and their impact on the management of the Pension Fund.

Background

2. In November 2015 the Government issued a consultation on proposed new regulations to replace the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (“the 2009 Regulations”).

3. The consultation ended on 19 February 2016 and the Local Government Pension Scheme (LGPS) (Management and Investment of Funds) Regulations 2016 (“the 2016 Regulations”) were published on 23 September 2016, following the issue on 15 September 2016 of Guidance from the Department for Communities and Local Government (DCLG) on Preparing and Maintaining an Investment Strategy Statement required by the 2016 Regulations (“the Guidance”).

4. The 2016 Regulations came into force from 1 November 2016. Copies of the 2016 Regualtions and the Guidance are included as Appendices to this report.

The 2016 Regulations

5. The 2016 Regulations are significantly different in approach to the 2009 Regulations. They contain fewer restrictions or limitations on what an LGPS Fund can invest in and, for example, expressly confirm that ‘derivatives’ count as ‘investments’. However there is a requirement for Funds to comply with the Guidance published by the Secretary of State, and there is now a power for the Secretary of State to intervene in the investment functions of an administering authority.

6. The regulations remove the restrictions in the 2009 Regulations that set limits on the percentage of an LGPS Fund that could be invested in a particular investment or type of investment. This removal is needed to allow LGPS pooling to take place, and also reflects a move to investing within a ‘prudent

framework' approach. The Guidance explains this approach, and consequent need for a Secretary of State power of intervention as follows:

> "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."

7. The regulations require the Council (as an administering authority), after taking 'proper advice', to formulate an investment strategy which must be in accordance with guidance issued by the Secretary of State. The Council is required to consult with "such persons as it considers appropriate" on the content of the proposed investment strategy, which must be published no later than 1 April 2017. The investment strategy must be reviewed and revised (if necessary) from time to time but at least every 3 years. The investment strategy must include:

- a requirement to invest fund money in a wide variety of investments;
- the Council's assessment of the suitability of particular investments and types of investments
- the Council's approach to risk, including the ways in which risks are to be assessed and managed;
- the Council's approach to pooling investments, including the use of collective investment vehicles and shared services;
- the Council's policy on how social, environmental and corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments; and
- the Council's policy on the exercise of the rights (including voting rights) attaching to investments.

8. The 2016 Regulations give the Secretary of State the power to issue directions to administering authorities if they fail to act in accordance with the Guidance issued on formulating an investment strategy, and allow the Secretary of State to direct the authority to:
- make specified changes to its investment strategy statement;
- invest some or all of the fund's assets in a specified manner;
- permit the Secretary of State (or a nominee) to exercise the authority's investment functions for a specific period or as long as is considered appropriate; and/or
- comply with instructions issued by the Secretary of State / nominee in relation to the exercise of its investment functions.

9. These directions may only be issued after consultation with the administering authority and after consideration of all reasonably available evidence regarding the authority's actual or proposed exercise of its investment functions.

Investment Strategy Statement Guidance

10. The Guidance issued on preparing and maintaining an Investment Strategy Statement incudes summaries of how administering authorities should comply with each of the following requirements set out in the 2016 Regulations:

11. *Investment of money in a wide variety of investments.*
In formulating and maintaining their policy on diversification, administering authorities:-
   - Must take proper advice
   - Must set out clearly the balance between different types of investments
   - Must identify the risks associated with their overall investment strategy
   - Must periodically review their policy to mitigate against any such risks

12. *The suitability of particular investments and types of investments.*
In formulating their policy on the suitability of particular investments and types of investments, administering authorities:-
   - Must take proper advice
   - Should ensure that their policy on asset allocation is compatible with achieving their locally determined solvency target
   - Must periodically review the suitability of their investment portfolio to ensure that returns, risk and volatility are all appropriately managed and are consistent with their overall investment strategy

13. *The approach to risk, including the ways in which risks are to be measured and managed.*
In formulating their policy on their approach to risk, administering authorities:-
   - Must take proper advice
   - Should clearly state their appetite for risk
   - Should be aware of the risks that may impact on their overall funding and investment strategies
   - Should take measures to counter those risks
   - Should periodically review the assumptions on which their investment strategy is based
   - Should formulate contingency plans to limit the impact of risks that might materialise

14. *The approach to pooling investments, including the use of collective investment vehicles and shared services*
In formulating and maintaining their approach to pooling investment, including the use of collective investment vehicles and shared services, an administering authority must
   - Confirm the pooling arrangements meet the criteria set out in the November 2015 investment reform and criteria guidance, or have been otherwise agreed by the Government
   - Notify the Scheme Advisory Board and the Secretary of State of any changes which result in failure to meet the criteria
   - Set out the proportion of assets that will be invested through pooling

- Set out the structure and governance arrangements of the pool and the mechanisms by which the authority can hold the pool to account
- Set out the services that will be shared or jointly procured
- Provide a summary of assets that the authority has determined are not suitable for investing through the pool along with its rationale for doing so, and how this demonstrates value for money;
- Regularly review any assets, and no less than every 3 years, that the authority has previously determined should be held outside of the pool, ensuring this continues to demonstrate value for money
- Submit an annual report on the progress of asset transfers to the Scheme Advisory Board

15. *How social, environmental or corporate governance considerations are taken into account in the selection, non-selection, retention and realisation of investments*
In formulating and maintaining their policy on social, environmental and coporate governance factors, an administering authority:-
- Must take proper advice
- Should explain the extent to which the views of their local pension board and other interested parties who they consider may have an interest will be taken into account when making an investment decision based on non-financial factors
- Must explain the extent to which non-financial factors will be taken into account in the selection, retention and realisation of investments
- Should not pursue policies that are contrary to UK foreign policy or UK defence policy
- Should explain their approach to social investments

16. *The exercise of rights (including voting rights) attaching to investments*
In formulating their policy on the exercise of rights, administering authorities:-
- Must give reasons in their Investment Strategy Statement for not adopting a policy of exercising rights, including voting rights, attaching to investments
- Should, where appropriate, explain their policy on stewardship with reference to the Stewardship Code
- Should strongly encourage their fund managers, if any, to vote their company shares in line with their policy under Regulation 7(2)(f)
- May wish to appoint an independent proxy voting agent to exercise their proxy voting and monitor the voting activity of the managers, if any, and for reports on voting activity to be submitted annually to the administering authority
- Should publish a report of voting activity as part of their pension fund annual report under Regulation 57 of the 2013 Regulations

17. Much of the information set out in paragraph 11 to 13 is already included within the Statement of Investment Principles – the document required under the 2009 Regulations which is being replaced by the Investment Strategy Statement. The information set out in paragragh 14 will be covered by an

explanation of the Council's decision to pool investments through the Border to Coast Pensions Partnership. The 2016 Regulations are the mechanism by which the Government is facilitating LGPS investment pooling and is also enforcing pooling, by requiring each LGPS Fund to demonstrate how it will meet the Government's pooling objectives.

18. The information set out in paragraph 15 relates to how social, environmental and corporate governance issues are taken into account in the investment process. This section generated a significant response to the Government's consultation – 98% of the 23,516 responses the Government received were from members of the public and these were 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. In practice, this restriction is unlikely to have any impact on the Pension Fund's investment approach.

19. The information set out in paragraph 16 relates to how the Pension Fund exercises its voting rights as an investor. This section will require the Council to have a more explicit approach to responsible investment issues, including a likelihood that the Council as administering authority to the Pension Fund should sign up to the UK Stewardship Code.

Next steps

20. The Council as administering authority to the Pension Fund needs to prepare consult on and publish an Investment Strategy Statement by 1 April 2017. For practical reasons it is reasonable for the consultation (with Pension Fund employers) to take place as the same time as the consultation on changes to the Funding Strategy Statement that is likely to be needed as part of the implementation of the current actuarial valuation.

21. The Council is required to take 'proper advice' in formulating the Investment Strategy Statement. The Investment Advisor and, if appropriate, the Pension Fund Actuary will be consulted during the preparation of the Investment Strategy Statement. Also, the section on investment pooling (as set out in pargraph 14) will be drawn up in consultation with other partner LGPS Funds in the Border to Coast Pensions Partnership.

Recommendation

22. Members are asked to note the information contained in this report.

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