North Yorkshire Pension Fund

Integrated Finance, Resources, County Hall, Northallerton, North Yorkshire, DL7 8AL

Emma Reynolds MP
Minister for Pensions
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

24 September 2024

Dear Minister,

Local Government Pension Scheme: Next steps on investments

North Yorkshire Council (North Yorkshire) welcomes the opportunity to respond to the Call for Evidence made in support of the first phase of the Pensions Investments Review.

North Yorkshire is the Administering Authority for the North Yorkshire Pension Fund (the Fund) which is part of the LGPS. The Fund has assets of approximately £5 billion and has over 130 employers.

In 2018, North Yorkshire's jointly owned pooling company, Border to Coast Pensions Partnership Limited (Border to Coast) began managing investments on behalf of the 11 Partner Funds and their 1.1 million members and 3,100 employers.

We have delivered against the original policy intent of pooling, to improve investment outcomes and develop the capacity and capability to support infrastructure investment, which has contributed to UK growth. Of the £45 billion of investments pooled through Border to Coast, over £10 billion is currently invested in the UK.

Examples of current UK investments include:

- Through a £90m commitment to the Quinbrook Renewables Impact Fund (QRIF), we are supporting the largest portfolio of stability pathfinder synchronous condenser assets in the UK as part of the continued decarbonisation of the electricity supply grid.

- Through a £90 million commitment to Macquarie GIG Renewable Energy Fund II, we are supporting Gwynt y Môr**,** a £2 billion wind farm, providing 1,950 GWh of renewable power a year to the grid; enough to power 430,000 households.

- An investment from which we have recently exited was through Endless, who invested £17m in Findel Education, based in Cheshire. They successfully doubled the business over three years through developing the management team, aligning employees, and focusing business models.

In setting those outcomes, Government can build on available foundations. The pathway to completing pooling was set out in response to the 2023 *Local Government Pension Scheme: Next steps on investments* consultation. Implementing the Good Governance recommendations would support targeted action where needed to drive higher standards.

Pools, whether LGPS or wider asset owners, working at sophisticated scale can engage and work with the Government to address long-term brakes on UK growth and disincentives to domestic investment.

The benefits of scale

There is a considerable body of evidence that scale in relation to pensions investments supports efficiency, greater expertise (including in-house investment capabilities) and access to a broader range of opportunities, including private markets investment. Border to Coast is a great example of scale being deployed effectively to support Partner Funds.

Investing at scale has delivered cost savings for the level of commitments made. As Border to Coast continues to develop capabilities, the expertise they deploy is allowing approaches such as Climate Opportunities and UK Opportunities to be developed, enabling support of smaller scale investments and more targeted strategies. Larger pools of assets enable greater sophistication, which in turn enables better engagement and influence to make the market, not just be a passive recipient.

It is also essential that achieving investment scale is not pursued in the absence of consideration of the administration of pensions and the quality of service that must be delivered to members and employers.

Partnership

Our success through Border to Coast is not simply based on scale and expertise, but on the strength of the partnership. Pooling successfully requires committed, capable, and dedicated LGPS funds with a shared vision.

Our partnership approach is reflected in our approach to UK investment, which enables the skills within Border to Coast to be combined with the local knowledge and connections of Partner Funds.

Benchmarking the success of pooling solely through sums pooled and deployed neglects the broader benefits our partnership delivers, including working together as active stewards and meeting reporting requirements. As we further develop our partnership, we are building additional resilience, capacity, and capability that will strengthen the affordability and sustainability of the LGPS.

Policy supportive of investment

Whether through creating larger pools of capital or incentivising investment decisions, the success of any attempt to increase UK investment, whilst honouring fiduciary duty, will be constrained by the extent to which there are sufficient investment opportunities and a policy and regulatory environment which can be relied upon over the long term.

We welcome initiatives the Government is undertaking to address long-term challenges in relation to planning, infrastructure and skills, as well as building capabilities, including through the UK Infrastructure Bank, British Bank, and National Wealth Fund, that are needed to support a pipeline of investable projects and create sustainable public-private partnership models. However, the impacts of these will be realised in the longer term; addressing disincentives in the tax system, including stamp duty on UK equities and reform of ISAs, may have shorter term benefits.

Yours sincerely

For and on behalf of
Councillor Angus Thompson
Pension Fund Committee Chair
North Yorkshire Pension Fund

Call for Evidence answers

Scale and consolidation

What are the potential advantages, and any risks, for UK pension savers and UK economic growth from a more consolidated future DC market consisting of a higher concentration of savers and assets in schemes or providers with scale?

In relation to pensions investments, scale has the potential to deliver significant benefits for savers and asset owners. Properly structured, it can deliver specific goals, such as more diverse capital allocation across private and public markets, accompanied by the tools necessary for success: notably, strong governance and oversight; investment expertise; and sophisticated procurement methods.

In 2022 The Case for Scale by CEM looked at the case for scale for pension schemes. Its findings were that asset pooling led to lower staff costs per assets invested (due to the ability to internalise certain investment capabilities) and to lower external management fees (due to the negotiating strength that comes from the value of mandates being placed, negotiated by professional investors whose interests are fully aligned with the ultimate asset owners).

The study found the most important features of funds for determining value added are:

- Active management, in that investors with more actively managed portfolios have created more value add.

- Internalisation, in that investors that manage more of their assets in-house rather than with external managers have produced more value add.

- Economies of scale, in that all other things being equal, larger investors have outperformed smaller investors.

This is supported by “Scale Economies, Bargaining Power, and Investment Performance: Evidence from Pension Plans” (March 2023)[1]. This demonstrates the benefits of economic scale in pension plan investments (particularly those with in-house investment capabilities): large plans have stronger bargaining power over their external managers in negotiating fees as well as access to better-performing funds, relative to small plans. They use this power to produce higher gross and net-of-fee return performance, particularly in private asset classes. Economies of scale in investment costs are particularly large for passively managed accounts and for publicly traded assets and are significantly lower for actively managed accounts and alternative (private) asset classes.

In seeking to harness the benefits of investing at scale, Government must carefully consider the implications of consolidation for pension fund administration for members and employers.

Government should also be clear that LGPS funds do not just manage assets, they administer pensions, and therefore the risk that ill-considered scale poses to the quality of service that can be delivered to members and employers.

To what extent has LGPS asset pooling been successful, including specific models of pooling, with respect to delivering improved long-term risk-adjusted returns and capacity to invest in a wider range of asset classes?

[1] Scale Economies, Bargaining Power and Investment Performance: Evidence from Pension Plans

Pooling successfully has required committed and capable LGPS funds with a shared vision, where all Partner voices are heard and recognise the power of compromise when setting policy and direction.

The key to long term success is good governance; this is highlighted by the World Bank's study of the Canadian system[2]. The "governance premium" is currently thought to be c.0.6% pa additional return (and could be as high as 1-2% p.a.); this relates primarily to the clear delegation of investment decision-making with strong oversight and scrutiny[3]. As much as 90% of long-term investment performance is driven by asset allocation. As such, value is driven by Partner Funds focussing on Strategic Asset Allocation, with implementation delivered through Border to Coast.

Our pooling model is built to deliver the objectives of the Partner Funds as long-term investors. As such, Responsible Investment principles are embedded into the investment approach. Strategies are launched with a focus on long-term outcomes such as Climate Opportunities, investing £2.6bn in projects and businesses that are expected to make a material contribution to decarbonising the global economy.

As an open DB scheme, illiquid assets such as Private Markets have a clear role in the LGPS investment strategy. However, historically many LGPS Funds were either too small or didn't have the capabilities to invest in private markets. For example, prior to pooling the 11 Partner Funds had invested c.£2.3 billion in infrastructure; since launch, they have committed over £5 billion. Border to Coast's private markets programme has received Partner Fund commitments totalling £16 billion.

We believe the best way to deliver long-term sustainable value on behalf of multiple Funds is through the creation of an FCA-regulated organisation. This enables provision of investment management, associated tax efficient pooled vehicle operations, and advisory services through a centre of expertise focussed on and delivering for LGPS. It also enables stability of governance structures for investment decision-making.

Research into value for money by asset management data company ClearGlass Analytics[4], ranked Border to Coast number one in its efficiency index of over 1,000 pension schemes globally. Their leading position is due to scale, governance and blend of internal and external management.

Costs versus Value

Is there a case for Government interventions, aimed at employers or other participants in the market, designed to encourage pension schemes to increase their investment budgets in order to seek higher investment returns from a wider range of asset classes?

In general, a shift away from a focus on cost towards the value delivered and net of fees risk adjusted returns would be welcomed across the industry as enabling a shift away from lowest common denominator investment strategies.

Border to Coast has delivered over £100 million in savings since its launch in 2018 launch and is on track to deliver over £500 million by 2032. However, the continued benchmarking of savings against 2016 is increasingly irrelevant, both in terms of the changing economic environment in which the LGPS operates and the evolving policy objectives for pooling, including greater UK and private markets investment, with its widely recognised higher cost in delivering improved outcomes.

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[2] https://documents1.worldbank.org/curated/en/780721510639698502/pdf/121375-The-Evolution-of-the-Canadian-Pension-Model-All-Pages-Final-Low-Res-9-10-2018.pdf

[3] https://www.pensionspolicyinstitute.org.uk/research-library/research-reports/2017/2017-02-13-briefing-note-89-defined-benefits-the-role-of-governance/

[4] https://henrytapper.com/2023/06/03/how-pooling-can-deliver-vfm-chris-sier-looks-at-border-to-coast/

The success of pooling should be benchmarked against a framework focused on value for money both in terms of net of fees investment performance and the broader contribution made by the pool to the capacity, capability, and resilience of the LGPS. Should the Government seek to measure commitments to 'productive assets', the term should be clearly defined. We would highlight that as an FCA regulated asset manager, Border to Coast already complies with the FCA's Assessment of Value requirements.

As the private DB market continues to mature and become a smaller part of the pensions landscape, it is essential that regulation (and guidance for the LGPS) continues to recognise the need and desirability of the remaining open DB and LGPS funds to continue to take appropriate risk. We would welcome thoughtful guidance to support the LGPS in considering the appropriate level of investment risk.

Investing in the UK

What is the potential for a more consolidated LGPS and workplace DC market, combined with an increased focus on net investment returns (rather than costs), to increase net investment in UK asset classes such as unlisted and listed equity and infrastructure, and the potential impacts of such an increase on UK growth?

As is widely understood, and underlined in recent Pensions Policy Institute research[5], asset allocation is primarily driven by desired member outcomes and the membership and maturity of a scheme. It is important that any measure to drive investment in particular asset classes or geographies is understood in that wider context.

Increased scale can deliver specific goals, such as more diverse capital allocation across private and public markets, accompanied by the tools necessary for success: notably, strong governance and oversight; investment expertise; and sophisticated procurement methods.

Scale has a clear link with the ability to invest in a wider set of asset classes. Data from CEM highlights that a typical £1 billion Fund invests 11% in private markets; a £20 billion fund invests 20%; and a £100 billion Fund invests 23%.

Scale and sophistication have enhanced our ability to deliver productive finance in the UK. In May 2024 Border to Coast launched 'UK Opportunities' which is designed to deliver this. Workshops have been held with Border to Coast and Local Authority economic development offices, Home England, and British Business Bank, seeking to build a two-way flow of information and engagement with investment managers, and with local stakeholders to create opportunities for investment. Larger pools of assets enable greater sophistication, which in turn enables better engagement and influence to make the market, not just be a recipient.

It is important that each Fund has the appropriate resource and capability to succeed - which tends to be associated with scale. The final draft of Good Governance provisions set out a mechanism for assessing individual funds on a range of factors through a biennial Independent Governance Review (IGR). The introduction of an IGR can enable the identification of poorly governed Funds. Those Funds that fail to meet the high standards expected would be expected to find a solution or be the subject of targeted action.

Local accountability is a key principle of the LGPS and Government should be mindful that LGPS Funds are responsible for the administration of pensions which must be carefully considered as part of any structural change.

[5] 'Pension scheme assets – how they are invested and how and why they change over time'

What are the main factors behind changing patterns of UK pension fund investment in UK asset classes (including UK-listed equities), such as past and predicted asset price performance and cost factors?

The LGPS is already a significant investor in the UK. For Partner Funds in border to Coast, of the £45 billion of pooled investments, over £10 billion is currently invested in the UK and this will increase with the imminent launch of the UK Real Estate fund which is expected to grow to £4 billion.

The long-term decline in domestic investment in the UK market, particularly in relation to UK-listed equities, has been well-chronicled and factors include:

- Long term historic underperformance. The average annual total return from 1998 to 2023 for the FTSE All Share was 5.2%, and the MSCI World was 7.7%, due to the mix of relative valuation, multiple contraction, and earnings growth.

- Structure. The UK market is skewed to old economy sectors (Energy, Materials, Financials) with less exposure to growth (Tech, Healthcare).

- Lack of dynamism. There have been minimal IPOs, overseas takeovers of growth companies, and companies moving listings to higher valued markets.

- Complex and expensive listing requirements. Listing requirements should be consistent with international standards and balance interests of both business owners, operators and equity market investors.

- Stamp Duty on share transactions. This currently raises c.0.3% of UK Tax revenue but has a disproportionate negative impact on the economy. Revenues on this duty have remained broadly flat for 25 years[6]. There is a material cost disadvantage vs the US and several major European markets (UK: 0.5%, US and Germany: 0%, France: 0.3%).

There are also challenges in the planning system, which have long acted as a disincentive to UK investment. The lack of long-term policy certainty, particularly in the case of infrastructure, has further been a hindrance. We hope the Government's proposals to strengthen the National Infrastructure Commission delivers progress. Government also has a fundamental role to play in supporting a pipeline of investable projects and creating sustainable public-private partnership models. Clear and stable industrial and skills strategies will also be important.

Domestic allocation by pension funds is a matter of debate globally. Recent research examined the decrease in domestic investments by Canadian pension funds over the last decade and risks identified with mandating domestic investment.[7] Similarly, to focus overly on domestic investment is to ignore the benefits the UK enjoys from being part of a global investment ecosystem. Indeed, research highlights that while enforced domestic investment can deliver a short-term boost, it can ultimately harm local markets[8].

Is there a case for establishing additional incentives or requirements aimed at raising the portfolio allocations of DC and LGPS funds to UK assets or particular UK asset classes, taking into account the priorities of the review to improve saver outcomes and boost UK growth? In addition, for the LGPS, there are options to support and incentivise investment in local communities contributing to local and regional growth. What are the options for those incentives and requirements and what are their relative merits and predicted effectiveness?

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[6] https://www.peelhunt.com/news-insights/articles/stamp-out-stamp-duty/

[7] 'Should Canada Require Its Pension Funds to Invest More Domestically?'

[8] "Is locking domestic funds into the local market beneficial? Evidence from the Polish pension reforms", Anna Zalewska, 9 Nov 2006

The LGPS has a fiduciary duty to scheme members and employers and must ensure the sustainable and affordable payment of pensions. Requirements to invest in specific geographies or asset classes risks infringing on that. Given the factors set out above, no credible asset allocation model would result in dramatic short-term increases in UK allocations – particularly for listed markets. As highlighted above, enforced domestic investment can ultimately be detriment for the domestic market.

Further, such requirements would drive unfavourable outcomes including distorting effects as capital is driven into markets that are not ready to receive it, negatively impacting returns, and is withdrawn from other asset classes in a way that incurs potential loss of value and additional costs. Imposing requirements also fails to address whether funds have the capacity and capabilities to meet them.

The geographies the Partner Funds in Border to Coast represent include seven of the ten most deprived areas in the Index of Multiple Deprivation, with a consequent motivation to channel investment which drives job creation, productivity, and improved quality of life. However, 'local' impact needs to be delivered through a strategic and sustainable programme of investment.

Far from inhibiting local investment, Partner Funds have concluded directing such investment through Border to Coast brings the benefits of their investment expertise, and the potential to "crowd in" investment from investors in the LGPS. This approach also reduces the concentration risk associated with Funds investing in the same region that ultimately provides the tax base for that local authority. Our partnership approach also facilitates relationship building between local authorities, funds, and investors, with opportunities to raise the profile of local investment.

We strongly recommend any Government definition of local investment stresses investment in physical, social, or intellectual capital in the UK, achieving the required investment returns for an appropriate level of risk. Any requirement in relation to private markets should encompass the whole range of private asset classes and across the capital structure, including real estate, private credit, and infrastructure in addition to private equity.

Policy certainty, building capabilities and addressing tax disincentives (such as those outlined above in Investing in the UK, and additionally with respect to differences in the treatment of SDLT across Scotland, England, and Wales) are more likely to have positive impacts. For example, in terms of building capabilities, the National Wealth Fund (NWF) represents a potential partner for the LGPS. If the NWF can de-risk new projects with its catalytic capital, LGPS partners could potentially provide the next wave of capital into those projects.