

APPENDIX 1

6 February 2009

Addressees as below

Dear Colleague

The Local Government Pension Scheme (Management and Investment of Funds) (Consolidation) Regulations 2009

1. With Ministers' agreement, I enclose for your comments draft regulations which would consolidate the Local Government Pension Scheme (Management and Investment of Funds) Regulations 1998 ("the investment regulations"), SI 1998/1831, and also make various amendments.

SCOPE OF PROPOSALS

2. This consultation exercise is primarily a consolidation of the 1998 regulations, as amended, but does include several proposals on separate bank accounts, borrowing, and employer-related loans, which Ministers agreed last summer should be taken forward for consideration by interested parties. A list showing the content and order of the proposed consolidated regulations is attached at **Annex A**.
3. Your comments on the proposals are invited by **3 April 2009**. An eight weeks consultation period is being provided rather than twelve weeks, because what is being proposed has been informally in the public domain for some months. Consultees who wish to discuss the proposals are invited to contact the Department to allow any meetings to take place within the consultation period.

PART I - THE PROPOSED REGULATIONS

Introduction

4. The intention is for the Regulations to come into effect later this year.

5. Scheme interests will be aware that **regulations 11 to 14 of the LGPS (Miscellaneous) Regulations 2008**, SI 2008/2425, made minor amendments to the investment regulations, to update references they contain to the other regulations for the Scheme.¹ The draft investment regulations now reflect those earlier changes.

Key Proposals

Separate bank account for the pension fund - regulation 6

6. The intention of this amendment is to improve the transparency of cash transactions between pension funds and general local authority accounts, and follows long-standing Audit Commission best practice. We understand that many administering authorities already have a separate bank account and, from informal discussions with interested parties, the only significant concern expressed by those who do not is that the amending regulations must allow sufficient lead-in time to enable authorities to introduce new arrangements without any detriment to their investment strategies. In addition to any general comments about this proposal, consultees are therefore also invited to comment on what would be a suitable and practical lead-in time before any change took effect.

Temporary borrowing power- regulation 15

7. Regulation 15 proposes that a fund administering authority should have an explicit, but limited, power to borrow for the purposes of its pension fund. Borrowing in order to invest on behalf of the fund would not be allowed.
8. It is understood that there can be occasions where limited short-term borrowing does, unexpectedly, prove to be necessary for cash flow purposes - for instance as a part of transition management when the allocation of the fund's assets is being changed, or to ensure that all scheme benefit payments can be made on time. The pension fund needs to have identifiable known income it will receive shortly, with which repayment of the amount borrowed can be funded. The cost of the relevant loan repayments, and any interest payable, would be chargeable to the pension fund.
9. The amendment will therefore clarify the legal position of Part 1 of the Local Government Act 2003 which deals with the capital finance provisions of local government finance legislation and which provides a borrowing power for local authorities, but only in respect of their general local authority functions. The draft provision was recommended by CIPFA in July 2008 after its initial review of the extant regulations.

¹ CLG's letter of 17 September 2008 refers – paragraphs 5.19 and 5.20.

Statement of Investment Principles (SIP) : stock lending - regulation 11(2)(h)

10. Draft regulation **11(2)(h)** extends the existing regulation on this subject to require an authority's statement of investment principles (SIP) to include information about its policy on the lending of stocks or other securities from its LGPS pension fund.

Stocklending – References to COLL - regulation 3(8) & 3(9)

11. Draft regulation **3(7) & (8)** (definition of “investment”) update references to the relevant Financial Services Authority Sourcebook, now called COLL. They adapt COLL chapter 5.4 to the LGPS context, by making the administering authority responsible for compliance with the rules and guidance specified. The full contents of COLL 5.4 can be seen at <http://fsahandbook.info/FSA/html/handbook/COLL/5/4>
12. CLG does not think that regulation **3(8)** needs to include a reference to COLL 5.4.8G. It is only guidance, and the overall provisions of the LGPS investment regulations cover relevant points already. That approach can be reviewed, however, if consultees consider that a reference is necessary. Were a reference to 5.4.8G to be added to regulation 3(8), it would have to include appropriate modifications - paragraphs 1 and 2(b)(ii) of COLL 5.4.8G would therefore not apply.
13. Consultees should note, and may have comments regarding, ways in which COLL chapter 5.4 is different from the equivalent section of the previous Sourcebook. Namely:
 - Counterparties may now include certain USA broker-dealers and banks – see 5.4.4(1)(b) (iii) and (iv). CLG is minded to provide a modification in regulation 3(8) of the new investment regulations, so that COLL 5.4.4(1)(b) (iii) and (iv) would not in fact apply to LGPS Funds.
 - The difference in arrangements for stock lending transactions made through the Euroclear Programme are mentioned at 5.4.4(3)
 - (Although as explained above this is unlikely to be relevant, 5.4.8(2) has guidance on how cash collateral can be reinvested.)
14. These changes were explained in an FSA Quarterly Consultation which can be found on their website - FSA 06/18, (No.10) October 2006, paragraphs 6.28 to 6.41.

The SIP and risk - regulation 11(2)(c)

15. An authority's Funding Strategy Statement will already provide some related information on investment strategy and managing financial risks. Draft regulation 11(2)(c) proposes to extend the existing requirement for an administering authority's statement of investment principles to cover its policy on risk, by adding the words “including the ways in which risks

are to be measured and managed”. The amendment reflects a similar requirement on private sector pension schemes.

Reference to overriding regulations concerning employer-related investments - regulation 13(1)

16. The Explanatory Note to the existing regulations does mention that overriding regulations exist, the latest version being the Occupational Pension Scheme (Investment) Regulations 2005, SI 2005/3378 (“OPSIR”). But there is currently no reference to these in the body of the LGPS investment regulations.
17. To clarify the situation, draft regulation 13(1) contains a reference to the relevant provisions of OPSIR.
18. Further information about OPSIR is at **Annex B**. The full text can be seen at http://www.opsi.gov.uk/legislation/about_legislation.htm Use the advanced search, or follow the links from the home page to Legislation – Original – UK Statutory Instruments SIs – Year 2005 – No. 3378.

Use of Fund Money by the Administering Authority - Revocation of existing regulations 3(4) and 12

19. A provision of this kind has featured in the relevant Superannuation Act or scheme regulations since 1937 (with changes to details as time went on), and is subject to the prudential requirements and limits in the current regulations as a whole.
20. Although it is perhaps arguable that such use represents a safe investment, with the daily interest rate payable being prescribed, after many changes over the years in the wider pensions world it has come to be seen by some commentators as being out of step to allow administering authorities to use fund money in this way. There is no obvious reason why the administering authority should be able to do so when other participating employers cannot. CLG has therefore concluded that when the 1998 regulations are revoked, existing regulations 3(4) and 12 will not be replicated in the new provisions.
21. A transitional provision is proposed at draft **regulation 16**. This is only intended to be used where appropriate and to enable such arrangements to be unwound in an orderly manner without detriment to the fund.

PART II - OTHER FUTURE DEVELOPMENTS

Conflicts of Interest

22. The Pensions Regulator issued guidance for trust-based occupational schemes in 2008 as part of its Trustee Training Toolkit. (<http://www.thepensionsregulator.gov.uk/trustees/trusteeKnowledge/tku-02.aspx>.)

23. Within the LGPS, conflicts could potentially arise in relation to funding and investment matters between the administering authority and participating employers; or on administration, and for example on matters such as policies on discretions, between employers and scheme members.
24. Following the well-established tradition of adopting in the LGPS useful features of the regime for private sector occupational schemes, we intend to come forward in 2009 with scheme-specific best practice guidance to identify and manage potential conflicts of interest. Scheme interests will be consulted in the usual way before the guidance is issued.

Other Issues - duty of care, governance

25. Regulation 4 of The Occupational Pension Schemes (Investment) Regulations 2005, which applies only to private sector schemes, imposes the following requirements :

“Investment by trustees

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(a) (power of investment and delegation) must exercise the discretion, in accordance with the following provisions of this regulation.

(2)

(3) The powers of investment, or the discretion, must be exercised in a manner calculated to ensure the security, quality, liquidity and profitability of the portfolio as a whole.”

The provision usefully summarises the fiduciary duty of private sector pension fund trustees, and the investment outcomes which the prudential investment provisions of such regulations would be seeking to achieve.

26. More recently, the CIPFA Pensions Panel Working Group’s report on its 2008 review of the LGPS investment regulations proposes, amongst other things, the following definition of “investments” :

“The assets of the pension fund must be invested in such a way as to ensure the security, quality, liquidity and profitability of the portfolio as a whole and, in doing so, take the appropriate market, risk and investment advice. In the event of a potential conflict of stakeholder interests, investments must be made in the sole financial interests of the fund.”

27. CLG has tended to take action to ensure that the LGPS reflects private sector best practice and sustains its position as an exemplar occupational scheme. On this basis, consultees are invited to consider whether a provision of this kind is desirable or necessary to clarify the

duty of care owed by those responsible for investment decisions within the LGPS.

28. Consultees are therefore invited to comment on the merits of this proposal; and, in particular, whether the approach taken by the 2005 regulations mentioned above, or the wording above suggested by CIPFA, is appropriate in the LGPS context. CIPFA's report was published on 28 January 2009, and will be available on the Department's website. See the "What's New 2008-2009" page at www.xoq83.dial.pipex.com
29. Other developments within the general area of governance are expected to be considered during 2009, once CLG has had the opportunity to analyse the first governance compliance statements prepared by administering authorities in accordance with the relevant statutory guidance.

Use of information

30. This consultation will be available for viewing on the LGFPS website - www.xoq83.dial.pipex.com. A summary of responses will be published within 3 months of the close of the consultation on this website.
31. 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).
32. 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.
33. The Department will process your personal data in accordance with the DPA and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties.

Responses

34. **Your comments should be sent by 3 April 2009 to Margaret Dunleavy**, Workforce Pay and Pensions Division, Department for Communities and Local Government, Zone 5/F8, Eland House, 123

Victoria Street, London, SW1E 6DE. Electronic responses can be sent to margaret.dunleavy@communities.gsi.gov.uk

Yours faithfully,

Robert Holloway

List of Addressees

The Chief Executive of:

County Councils (England)
District Councils (England)
Metropolitan Borough Councils (England)
Unitary Councils (England)
County and County Borough Councils in Wales
London Borough Councils
South Yorkshire Pension Authority
Tameside Metropolitan Borough Council
Wirral Metropolitan Borough Council
Bradford Metropolitan City Council
South Tyneside Metropolitan Borough Council
Wolverhampton Metropolitan Borough Council
London Pension Fund Authority
Environment Agency

Town Clerk, City of London Corporation
Clerk, South Yorkshire PTA
Clerk, West Midlands PTA

Fire and Rescue Authorities in England and Wales
Police Authorities in England and Wales
Audit Commission
National Probation Service for England and Wales
Homes and Communities Agency (New Towns Pension Fund)

Local Government Association (LGA)

Local Government Employers (LGE)
LGPC
Association of Colleges

ALACE
PPMA
SOLACE
CIPFA

Association of Consulting Actuaries
Association of District Treasurers
Society of County Treasurers
Society of Welsh Treasurers
Society of Metropolitan Treasurers
Society of London Treasurers

NALC
Society of Local Council Clerks

Trades Union Congress	UCATT
UNISON	GMB
NAEIAC	NAPO
UNITE	

GAD
SPPA
HMT

HMRC
DOE (NI)
DWP

Financial Services Authority (FSA)
Investment Management Association (IMA)
Association of British Insurers (ABI)
National Association of Pension Funds (NAPF)
London Investment Banking Association (LIBA)
LAPFF
PIRC

Hymans
Mercer
Hewitt
Barnett Waddingham
Linklaters
Pinsent Masons

Annex A - Contents of SI

The Local Government Pension Scheme (Management and Investment of Funds) (Consolidation and Amendment) Regulations 2009

Preliminary

1. Citation, application and commencement
2. General definitions
3. Definition of “investment”
4. Definition of “investment manager”

Management of pension fund

5. Management of Pension Fund
6. Separate bank account **NEW**
7. Choice of investment managers
8. Terms of appointment of investment managers
9. Review of investment manager’s performance

Use and investment of pension fund money

10. Investment of pension fund money
11. Statement of investment principles – **amendments at 11(2)(c) and 11(2)(h)**
12. Investments under section 11 of the Trustee Investments Act 1961
13. Restrictions on investments. See also Schedule 1 – **note 13(1)**
14. Requirements for increased limits
15. Power to borrow – **NEW**
16. Use of fund money by the administering authority – **NEW - transitional provision, consequent on proposed removal of current regulations 3(4) and 12**

Supplementary

17. Consequential amendments and revocations. See also Schedule 2.

SCHEDULE 1

LIMITS ON INVESTMENTS - This is in the form of a Table

EXCEPTIONS TO LIMITS IN THE TABLE

INTERPRETATION

Please Note

A reference in the draft SI to “paragraphs 1 to 3” of Schedule 1 will be to the relevant paragraphs in the part of the Schedule called EXCEPTIONS TO LIMITS IN THE TABLE. See the example in draft regulation 13(6).

Such a reference does **not** mean items 1 to 3 **of the Table** in the part of the Schedule called LIMITS ON INVESTMENTS

SCHEDULE 2 : CONSEQUENTIAL AMENDMENTS

Annex B

The Occupational Pension Scheme (Investment) Regulations 2005 (“OPSIR “), SI 2005/3378

Employer-related investments

Briefly, the key provisions are :

i) that “employer related loans” as defined there, are not allowed. *Reg 12(2)(b) and 12(4)*.

Such loans include, as explained at *reg 11(b) and 11(c)* respectively, any guarantees given to secure obligations of the employer, and third party loans. Also, by virtue of section 40(3) of the Pensions Act 1995, any unpaid debts owed to the scheme by participating employers *regulation 12(4)(a)*.

ii) any employer-related investment which is a transaction at an undervalue is forbidden, no fund resources can be used for this.² *Reg 12(3) and definition at reg 12(5)*. A transaction at an undervalue would seem to be when fund resources are given to the employer for nothing, or where the consideration received from the employer in return is less than the value in money or money’s worth of the fund resources handed over.

iii) other “employer related investments” as defined in OPSIR are limited to 5% of the “current market value of the resources of the scheme”. *Reg 12(2)(a)*

(Meaning that, for example, for the purposes of Schedule 1 of the LGPS investment regulations, any investments that are permissible “employer-related investments” in the OPSIR sense - would be limited to 5% of the fund.)

NOTE – This summary description does not in any way constitute legal advice. It is merely intended to give an informal outline of the scope of the OPSIR provisions. Any LGPS fund authority taking any investment decision on which OPSIR could have any bearing, should obtain their own legal and other relevant advice.

² Applies to any transaction on/after 6 April 1997.