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Update

Proposed changes to LGPS investment regulations

Under proposals announced last week, local authority pension funds are to be permitted to increase their allocation to infrastructure assets.

The Government last week issued a consultation on a proposed relaxation of the rules restricting the amount of the fund that local authority pension funds can invest in partnership vehicles. The aim of the proposal is to help local authority pension funds who wish to invest in the new Pensions Infrastructure Platform and other infrastructure funds. The consultation closes on 18 December.

It is increasingly being recognised by pension funds and other institutional investors that infrastructure can offer stable, long-term, inflation-linked returns that match pension fund liabilities. Low gilt yields are further increasing the appetite of pension funds for exposure to infrastructure, whilst the contraction of available bank funding increases the infrastructure industry's desire to attract investment from institutional investors.

The Investment Regulations

The current restrictions on the investments that can be made by local authority pension funds are set out in Schedule 1 of The Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. The restrictions cover a wide range of asset classes, such as unlisted securities, unit trusts and other collective investment schemes, and insurance contracts.

Up to 15% of the fund can be invested in "partnerships": many private equity funds, property funds and infrastructure funds are structured as limited partnerships, so this effectively restricts the fund to an allocation of 15% in total to all of these asset classes. The limit was as low as 5% until 2003. Many local government pension funds already have significant exposure to partnership vehicles (for example through private equity funds) and are therefore unable to take advantage of the new opportunities to invest in infrastructure.

The consultation paper refers to the National Association of Pension Funds' lobbying efforts, in which the NAPF raised concerns that the current investment restrictions are hindering local authority pension funds who wish to increase their exposure to infrastructure as an asset class. The Government recognises that the current restrictions are no longer appropriate.

The consultation paper proposes amending the regulations to facilitate investment by local authority pension funds in infrastructure assets. The paper says that this aim could be achieved either by increasing the maximum exposure to partnerships to 30% of the fund, or by introducing a new asset class for "infrastructure."

Comment

The industry will welcome the proposed changes to allow local authority pension funds to increase their exposure to infrastructure, where the administrating authorities consider that this would improve the quality of their investment portfolio and the funding level of their scheme.

The better way to implement the proposed changes is to increase the maximum allocation to partnerships from 15% to 30% of the fund. The creation of a new asset class for infrastructure is likely to create more problems than it solves. Firstly, there is the problem of defining "infrastructure": the pension funds would need to ensure that the investment guidelines of any infrastructure fund they invested in were drafted so as to restrict investment to assets that fell within the statutory definition. It is unlikely that most infrastructure funds on the market will have such restrictions in their documentation.

Secondly, many local authority pension funds will already have exposure to infrastructure assets through other parts of their portfolio – for example, by holding listed securities in energy companies, or by investment in a collective investment scheme that holds such securities. It would be extremely difficult (if not impossible) for the pension funds to monitor their exposure to infrastructure assets across their portfolio as a whole.

It is to be hoped that in future the Government will also address the wider issue of why local authority pension funds are subject to investment restrictions that other occupational pension funds are not. It is time for a fuller review of these restrictions, to enable local authority pension funds to keep up with a rapidly changing economic environment, and to continue to invest the funds with the aim of achieving the best returns for members.

Further information

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