LGF Pensions Team
Department for Levelling Up, Housing and Communities

By e-mail: LGPensions@levellingup.gov.uk

2 October 2023

Dear LGF Pensions Team

Re: Local Government Pension Scheme: Next steps on investments

The BVCA is the industry body and public policy advocate for the private equity and venture capital (private capital) industry in the UK. With a membership of around 650 firms, we represent the vast majority of all UK-based private capital firms, as well as their professional advisers and a large base of UK and global investors. We are happy for the content of this submission to be quoted in any future response the Government may issue.

Why the BVCA agrees with the direction of Government policy in this area

We welcome the Government's agenda of improving opportunities for UK pension scheme investment in productive finance, including private capital funds, and improving UK pension savers' retirement outcomes. The direction of Government policy here is supported by robust BVCA returns data which clearly demonstrate that the UK's private capital fund industry has a four-decade track record of delivering market-beating returns and diversification benefits for global institutional investors. Investment activity data provided by BVCA members also clearly demonstrate that UK pension schemes comprise only a very small part of the UK private capital fund industry's pension investor base, which is dominated by overseas public and private DB (and DC) schemes (alongside a range of other types of institutional investor).

We therefore applaud the DWP's objectives of encouraging consolidation amongst UK's pension schemes, where necessary, and facilitating their access to long-term, illiquid assets like private capital funds that offer diversification benefits and the potential for excess returns. The Mansion House proposals are an opportunity for the Government to improve retirement prospects for millions of UK pension savers by starting to level the playing field between UK schemes and other institutional investors with similarly long-term time horizons, such as charitable foundations.

Non-UK pension schemes, for example, can already improve the outcomes they achieve for their beneficiaries by building balanced, resilient portfolios with a broad range of assets, including illiquid strategies. Currently members of overseas pension schemes are benefitting from investment in UK growth companies via UK private capital funds, which offer different risk-return profiles and collectively have consistently outperformed public equities, in far greater numbers than members of UK pension schemes.

Below we have pulled out some of the key evidence for UK private capital's track record of outperformance and UK pension schemes' under allocations to it, with further evidence and data sources available in the BVCA's public response to DWP's recent call for evidence on defined benefit and on the BVCA Research webpages:

- Since 2001, investors would have earned 34% more from investing in funds managed by our members than if they made equivalent investments in the FTSE All-Share Total Return Index.

- Data from the BVCA's latest Report on Investment Activity shows that although 30% of all capital raised by UK PE/VC funds in 2022 came from pension schemes, often based in North America, only around 4% of that investment came from UK pension schemes.

- Independent commercial data from Preqin confirm that allocations to private capital funds by non-UK pension funds are typically much higher, with the Canadian pension schemes most active in private capital investment typically allocating on average 21% of their capital to private equity and the top US schemes averaging 14%, whilst even the UK private DB schemes most active in private capital on average allocate only about 5%.

There are specific considerations, beyond the general diversification and potential return benefits of private capital, that mean the LGPS in particular should be put in a position where funds and pools are able to make optimal use of private capital allocations when building members' portfolios. There is a commonly-cited argument that because LGPS is now broadly fully funded, investment strategies should be focussed entirely on de-risking. However, we would also argue that LGPS, despite being fully funded, also remain open to new members, which makes it essential (including to minimise the potential cost to taxpayers of any future deficits) that private capital should play a key role in the LGPS investment strategy. Also, in the context of the current inflationary environment, an approach to de-risking that relies on cash assets (as opposed to real assets like private capital funds) is likely to deliver insufficiently strong returns in the long run. Finally, in a period of financial constraint characterised by the 'bankruptcies' of certain Councils, private capital investments delivering strong returns that could help LGPS funds eventually to reduce the level of employer/employee contributions.

In addition, the UK private capital fund industry is a critical partner for Government in driving economic growth and ensuring that the UK's high-growth businesses of tomorrow can access the capital they need to start up and scale up in the UK. This is especially relevant in the current economic environment, which has imposed significant constraints on public borrowing. In 2022, £27.5bn was invested by private capital funds into UK businesses in sectors across the UK economy, ranging from consumer products to emerging technology. There are over 12,000 UK companies backed by private capital, which currently employ over 2.2 million people in the UK. Over 55% of the businesses backed are outside London and 90% of the businesses receiving investment are small and medium-sized businesses. The UK pensions industry urgently needs improved access to these innovative, unlisted UK companies that private capital funds identify and then support to realise their growth potential. The private capital fund industry's investment of capital and expertise in that collective potential is a powerful driver of broader economic growth across the UK.

We have responded below to the questions in the call for evidence on which our members have specific views. Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of our responses in more detail (please contact Tom Taylor (ttaylor@bvca.co.uk) and Nicholas Chipperfield (nchipperfield@bvca.co.uk)).

Tom Taylor
Head of Legal and Regulatory Policy
British Private Equity and Venture Capital Association

CHAPTER 2: ASSET POOLING IN THE LGPS

Q1: Do you consider that there are alternative approaches, opportunities or barriers within LGPS administering authorities' or investment pools' structures that should be considered to support the delivery of excellent value for money and outstanding net performance?

We support the Government's aim of delivering increased scale in LGPS investing. At the same time, we believe it is vital for levelling up purposes to ensure that any increased size of the pools does not itself prevent them from allocating to regional funds that are focussed on investing locally (and we have made some suggestions on how to protect flexibility for regional investment in our answer to Q11 below).

Generally, it is easier for larger investors to run effective private capital investment programs and diversify across managers, geographies and vintages, which is an important ingredient of effective investment strategies. So scale is important, and we would expect more complete and effective LGPS pooling to facilitate an increase in aggregate deployment into productive assets that would support value for money and improve net performance.

The World Bank's report on the Canadian pension system concluded that scale allows pension funds to access a broader range of assets, improve member outcomes and reduce costs. The World Bank also suggested that scale is important to make it economical for pension funds to invest in the level of in-house expertise required to select private capital fund managers, manage partner relationships and generally run a private markets program effectively. It is interesting also to note that Canadian pension schemes are increasingly establishing offices in the UK to facilitate their investment in UK-managed private capital funds (and several of these have joined the BVCA). We would further note the importance of establishing support for the creation of efficient and scalable funds across the pension funds industry, including amongst consultants and advisers, as seems to have been achieved in Canada.

Where investors have sufficient scale to bring this work in-house, according again to the World Bank, their returns (net of additional costs) are likely to improve, relative to where they rely exclusively on external advisers and consultants (which in the UK has consistently emphasised risk and further held back UK LGPS from developing successful private capital programs, as their international peers have done). This view is also supported by academic research from the Centre for International Finance and Regulation. Scale also allows investors' portfolios to achieve an appropriate spread of geographic, sector and asset class exposure across multiple funds, which also tends to result in stronger returns and broader diversification benefits.

It is important to emphasise that in-house teams will likely reduce or replace reliance on advisers and consultants, but not remove the need for external fund managers. Even the largest investors that command the scale to engage in some direct investments/co-investments in unlisted companies, typically also continue to make "limited partner" investments in private capital funds, as they provide asset diversification across multiple private companies (typically 10-15 per buyout fund and more per venture capital fund).

The World Bank's conclusions were supported by DWP analysis, in its 2018 white paper on Protecting Defined Benefit Pension Schemes, which concluded that consolidation would reduce UK pension schemes' running costs, improve their investment strategies (including by allowing a greater focus on illiquid investments), and bolster their governance, leading to improved outcomes for members. Further research demonstrating how scale facilitates private capital investments and improves pension fund performance been published by CEM Benchmarking and other academics.

These ways in which scale helps improve returns are confirmed by feedback from BVCA investor members that have themselves successfully executed private capital investment programs. These investors have told the BVCA that scale affords them greater resources which improve their access to investment opportunities, market knowledge and ability to negotiate favourable fund terms. These investors also report that scale increases investors' commercial ability to negotiate rights to be offered co-investment opportunities by a fund's manager. These rights give a fund's investors the chance to make further investments alongside the fund in existing portfolio companies and gain further, lower cost exposure to portfolio companies that are demonstrating strong performance post-acquisition. Scale also helps to support the investor's internal resources for effectively analysing the commercial potential of any such opportunities and allowing the investor to make an informed decision on whether to co-invest.

There are important nuances as regards scale in the context of LGPS pooling. Scale can further support better outcomes for the UK's regions, in addition to returns and diversification benefits, to the extent that it facilitates access for large local pension funds via regional private capital funds to investments in specific local projects that may directly benefit the funds' local members. However, at the same time **it will be vital for levelling up purposes to ensure that any increased size of the pools does not itself prevent them from allocating to regional funds that are focussed on investing locally**. These funds are typically positioned at the smaller end of the market, and the maximum amount of capital that any individual investor is typically willing commit to each fund in order not to constitute too large a portion of that fund's total capital alongside other investors is lower than it is for funds with a broader geographic reach. We have explained the challenges and solutions to this in our answers to Q7-Q10 below.

Q2: Do you agree with the proposal to set a deadline in guidance requiring administering authorities to transition listed assets to their LGPS pool by March 2025?

In principle, we agree with there being a deadline. The long-term horizons of pension funds should not mask that there is an urgent need to ensure that LGPS capital is being deployed as effectively as possible to support current and future members' retirements, so the sooner pooling is completed and made as effective as possible, the better. However, this urgency needs to be balanced against current positions and specific requirements of individual pools, and sufficient flexibility to reflect these should accompany any deadline.

It seems worth underlining that the process of transferring assets inevitably creates transaction costs, and that these costs are generally likely to be higher when the transferring assets are limited partnership interests in closed-ended funds holding unlisted stakes in private companies. Depending on their complexity, this kind of secondary transfer of an investor's (in this case the local pension fund) private capital fund interest to another owner (in this case a pool) will require formal transfer and 'GP consent' procedures under the private capital fund's constitution, adding legal and other costs. We would therefore support any Government intention to require only listed assets or otherwise those with lower transfer costs to be subject to transfers, with any increased investment in private capital funds to be made initially via the pools.

Q3: Should government revise guidance so as to set out fully how funds and pools should interact, and promote a model of pooling which includes the characteristics described above?

We support the introduction of further guidance to the extent that it helps establish broad principles and clearly identifies overall responsibilities for funds and the pools. Equally, we would recommend that any new guidance retain sufficient flexibility for governance models to react to the evolving economic and policy environment. We would also encourage the Government to continue to study and learn from the experiences of other countries that have executed successful consolidation policies, such as Canada, Australia and the Netherlands.

Q4: Should guidance include a requirement for administering authorities to have a training policy for pensions committee members and to report against the policy?

Private capital is fundamentally an institutional asset class that is, conceptually and from a regulatory perspective, principally appropriate for sophisticated professional investors, and private capital investment programs require specific expertise to execute successfully. It is critical that the right decision-makers are fully equipped with sufficient understanding of concepts and practice related to topics like multi-asset allocations, the role of various kinds of illiquid asset in delivering appropriate risk diversification, asset/liability matching and so forth (as well as an understanding of the mechanical and operational differences between the closed-ended private capital fund model and mainstream open-ended investment products).

We understand that trustees already receive some level training from certain LGPS funds, but relatively high turnover and lack of the background required to understand some of the complexities of private fund investments suggest that more in-depth and regular training, driven by clear and ambitious training policies, could help ensure these skills and expertise are present in the right places, and we would support requirements for training policies and reporting being included in guidance. Equally, we would note that training needs may be eased by investment strategies being set at asset class level.

Please refer also to the BVCA submission to DWP's consultation on pension trustee skills, capability and culture for further private capital perspectives on this issue.

Q5: Do you agree with the proposals regarding reporting? Should there be an additional requirement for funds to report net returns for each asset class against a consistent benchmark, and if so how should this requirement operate?

We fully support transparency in the reporting of costs, returns and other performance data. For example, in addition to its regulatory reporting obligations, the private capital industry has developed various tools and templates to help investors understand such as the Cost Transparency Initiative Private Markets Template (which the BVCA helped to develop, alongside the Local Government Association and the PLSA), the Invest Europe Investor Reporting Guidelines, and the Institutional Limited Partners Association Reporting Template.

We would support the standardisation of asset allocation reporting based on existing frameworks, both to reduce data costs, promote clear comparisons and build on existing familiarity in the advisory and asset management markets.

We are less enthusiastic about the proposals for reporting on the savings gained from pooling. This is not part of standard reporting for or by other investors, seems difficult to measure in a meaningful way and, crucially, we think has the potential to perpetuate a broader UK pensions industry focus on costs at the expense of value creation and total returns. Savings reporting seems also to entail a high risk of delivering misleading results and the wrong incentives, where cost-cutting success could mask a decline in overall investment performance. This would seem to be at odds with The Pensions Regulator's focus on ensuring that the UK's pensions industry considers costs in the broader context of returns. If the Government wishes to create reporting metric that provides evidence of the effects of pooling, it may wish to consider instead whether metrics related to overall net returns might better achieve that objective.

We support the proposal for asset class level reporting by the pools, because they bear the responsibility for selecting managers in different asset classes, so asset level performance seems to us to be a valid component of the pools' own performance. Local funds are responsible for ensuring that liabilities to members are met, and have targeted strategies that vary according to individual funds' funding, maturity and risk appetite – asset class level performance is not the key metric in this context, and reporting on it could give misleading impressions and incentivise investment decisions aimed at improving non-core metrics.

CHAPTER 3: LGPS INVESTMENTS AND LEVELLING UP

Q7: Do you agree with the proposed definition of levelling up investments?

Yes. The BVCA represents members from across the full spectrum of private capital firms, from the smallest local venture firms to the largest global private equity firms. These firms collectively invest their investors' capital across the whole of the UK. Our 2022 Report on Investment Activity demonstrates that 55% of businesses receiving investment via our members' funds last year are located outside London. 90% of the UK businesses receiving private investment in 2022 were small or medium sized companies (i.e. employing 250 or fewer people). Typically fast-growing and innovative, these are important drivers of improved productivity, pay, jobs and living standards in the UK's regions (the first mission listed in the white paper on Levelling Up the UK). This regional investment requires regional expertise and knowledge, so many of our member firms are themselves based in the UK's regions. Their strategy is typically to identify local businesses that, with private capital investment and operational support, can become national and international businesses of strategic importance whilst remaining headquartered in the regions where they were conceived. We also urge the Government to be mindful of the Supreme Court's decision in *R (on the application of Palestine Solidarity Campaign Ltd and another) v Secretary of State for Housing, Communities and Local Government*, which held that ministerial guidance, given to administering authorities of LGPS funds on how to discharge their investment powers, was unlawful. We believe it is in all parties' interests for any requirements and guidance to be implemented in a manner that stands up to legal scrutiny.

Q8: Do you agree that funds should be able to invest through their own pool in another pool's investment vehicle?

This proposal seems to offer local funds greater choice and more equal access to a broader range of investment opportunities. However, implementing this flexibility could be complex to execute. For example, we would urge the Government to carefully work through incentives and potential conflicts to ensure that an investment by a fund in another pool's vehicle does not unfairly disadvantage either that fund or the funds that are already invested in the vehicle in question.

We also note more broadly that the concern underpinning the need for this flexibility should lessen as a result of more complete and effective pooling.

Q10: Do you agree with the proposed reporting requirements on levelling up investments?

We would note that "levelling up" is not an asset class and query whether this would fit alongside reporting on asset class performance in a broader annual report. We think it may be more appropriate to separate reporting on this issue, perhaps as part of reporting on a fund's wider impact strategy or in an entirely separate levelling up report.

CHAPTER 4: INVESTMENT OPPORTUNITIES IN PRIVATE EQUITY

Q11: Do you agree that funds should have an ambition to invest 10% of their funds into private equity as part of a diversified but ambitious investment portfolio? Are there barriers to investment in growth equity and venture capital for the LGPS which could be removed?

Subject to appropriate level of flexibility on targets and definitions that we describe in more detail below, we warmly welcome the proposals for funds to have an ambition to invest 10% of their capital in 'private equity'. There are specific considerations, beyond the general diversification and potential return benefits of private capital, that mean the LGPS in particular should be put in a position where funds and pools are able to make optimal use of private capital allocations when building members' portfolios. There is a commonly-cited argument that because LGPS is now broadly fully funded, investment strategies should be focused entirely on de-risking. However, we would also argue that LGPS, despite being fully funded, also remain open to new members, which makes it essential that private capital should play a key role in the LGPS investment strategy (including to minimise the potential cost to taxpayers of any future deficits). Also, in the context of the current inflationary environment, an approach to de-risking that relies on cash assets (as opposed to real assets like private capital funds) is likely to deliver insufficiently strong returns in the long run. Finally, in a period of financial constraint characterised by the 'bankruptcies' of certain Councils, private capital investments delivering strong returns that could help LGPS funds eventually to reduce the level of employer/employee contributions.

Below we have pulled out evidence of UK private capital's track record of outperformance and UK pension schemes' under allocations to it, with further evidence and data sources available in the BVCA's public response to DWP's recent call for evidence on defined benefit and on the BVCA Research webpages:

- Since 2001, investors would have earned 34% more from investing in funds managed by our members than if they made equivalent investments in the FTSE All-Share Total Return Index.

- Data from the BVCA's latest Report on Investment Activity shows that although 30% of all capital raised by UK PE/VC funds in 2022 came from pension schemes, often based in North America, only around 4% of that investment came from UK pension schemes.

- Independent commercial data from Preqin confirm that allocations to private capital funds by non-UK pension funds are typically much higher, with the Canadian pension schemes most active in private capital investment typically allocating on average 21% of their capital to private equity and the top US schemes averaging 14%, whilst even the UK private DB schemes most active in private capital on average allocate only about 5%.

Whether the ambition is set at 10% or higher, we support the proposal for this to be an ambition rather than a requirement, because the circumstances of different funds vary and portfolio construction needs to remain at the discretion of the relevant decision makers at individual funds. We would also caution against the chosen figure being implemented or seen as a ceiling, given the evidence we offer above that 10% is a relatively low figure when measured against typical allocations to private capital of institutional investors globally.

We also think it important to maintain a greater degree of clarity on the types of asset are to be included in the calculation as to whether allocations meet the proposed ambition. "Private equity" at its most basic means "unlisted shares", and our first suggestion would be that this be broadened to also cover private credit investments. We also think it is important to make it clear that the target asset class includes the full range of private capital investments, as different pension funds will have different risk-reward appetites. Some may be comfortable investing in early-stage or minority growth equity, whilst others will prefer later stage buyouts (which covers both small and large private companies). A broad definition covering this range of 'private capital' assets we feel would be more appropriate and would allow LGPS to build private market strategies and satisfy risk appetites that suit funds' own circumstances.

It is also very important that the target asset allocation is not restricted to UK-based assets. All institutional investors need the freedom to build asset-class and geographically diversified portfolios in the interests of their ultimate beneficiaries. This need not cause concerns that such flexibility may lead LGPS to invest entirely outside the UK, because BVCA data show that over 50% of UK-managed private capital is invested into UK companies. As we have explained to the Government in various contexts, we believe this domestic bias removes any need to require UK pension schemes to invest a certain proportion of their capital into UK assets (and indeed the same principle is typically applied at private capital fund level such that there are relatively few private capital funds with investment strategies tied exclusively to UK assets).

However, we also believe that **an important unintended consequence of increased pooling** is likely to be, if it is not mitigated, that LGPS will find it significantly more challenging to invest in funds managed by smaller, regional fund managers, which typically invest in UK regional SMEs. Typically fast-growing and innovative, these businesses are important drivers of improved productivity, pay, jobs and living standards in the UK's regions (the first mission listed in the white paper on Levelling Up the UK). This regional investment requires regional expertise and knowledge, so many of our member firms are themselves based in the UK's regions. Their strategy is typically to identify local businesses that, with private capital investment and operational support, can become national and international businesses of strategic importance whilst remaining headquartered in the regions where they were conceived.

The challenge comes as a result of the average investment size increasing as funds are pooled and investment teams are streamlined, alongside fund concentration restrictions. We believe **this unintended consequence must be mitigated** such that LGPS can reap the benefits of consolidation whilst also maintaining level of regional investment that supports levelling up and generates strong returns for local pension savers. These solutions include:

- requiring or encouraging LGPS to dedicate a certain proportion of capital to smaller, regionally-focussed funds that can accept individual investor commitments of £20-40m; and

- ensuring that maximum concentration thresholds for LGPS investments are raised to 30-50% of a fund's total size.

We would warmly welcome the opportunity discuss this issue and the solutions further with the Government.

As per our answer to Q7, we also urge the Government to be mindful of the Supreme Court's decision in *R (on the application of Palestine Solidarity Campaign Ltd and another) v Secretary of State for Housing, Communities and Local Government*, which held that ministerial guidance, given to administering authorities of LGPS funds on how to discharge their investment powers, was unlawful. We believe it is in all parties' interests for any requirements and guidance to be implemented in a manner that stands up to legal scrutiny.

Q12: Do you agree that LGPS should be supported to collaborate with the British Business Bank and to capitalise on the Bank's expertise?

Yes. The BBB is a very important element of the UK private capital investment ecosystem. It has developed an impressive track record of investing successfully in UK private capital funds, for example through the Future Fund and Future Fund Breakthrough, and is well-known in the industry for Enterprise Capital Funds and the work of British Patient Capital. The BVCA warmly welcomed that the Mansion House announcements asked the British Business Bank to test proposals to build on the skills and expertise of its commercial arm. That currently has over £15bn of capital invested in over 20,000 companies. It would be beneficial to LGPS investment in higher performing private capital assets, as well as the levelling up agenda, if ongoing discussions between the Government and the BBB succeed in opening the bank's pipeline of UK growth investment opportunities to pension funds and more broadly sharing its practical expertise in this area.