Ministry of Housing, Communities and Local Government
2 Marsham Street
London
SW1P 4DF
United Kingdom

By email: LGPensions@communities.gov.uk

16 January 2025

Dear Local Government Policy Team,

Re: Local Government Pension Scheme (England and Wales): Fit for the future

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 over 600 firms, we represent the vast majority of all UK-based private capital firms, as well as their professional advisers and investors. In 2023, £20.1bn was invested by private capital 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 (SMEs).

We welcome the opportunity to provide feedback on this consultation on the Local Government Pension Scheme. Please do not hesitate to get in touch if you have any questions or if you would like to discuss any of the above in more detail (please contact Tom Taylor ttaylor@bvca.co.uk / Karen Hurst khurst@bvca.co.uk)

Executive Summary

- We welcome the Government's direction of travel on the LGPS, given the relationship between scale and the ability to invest in private markets, and the clear ambition for the role of the LGPS in generating regional and UK growth.

- However, it is not a given that further pooling will either protect or increase the ability of the LGPS to invest locally in the UK's nations and regions. Given the need for UK-wide economic growth and the LGPS' strong regional ethos historically, it is essential that the right measures are in place to ensure that pooling supports and improves its ability to invest in the UK economy (without introducing mandatory allocation requirements).

- Smaller UK private capital funds (venture capital and growth equity funds under £500m, including regionally focused private equity funds in the UK's lower mid-market) are a critical motor of the UK economy and drive strong returns for investors. LGPS pooling (and UK pensions consolidation more broadly) will only meet the Government's ambitions to boost UK economic growth if policy development focuses intently on ensuring that UK pension capital can be invested in these smaller funds, even as pools of pension capital grow larger.

- We support the following consultation measures, which are needed to ensure the LGPS can invest in smaller private capital funds, and therefore support investment in national and regional economic growth whilst generating strong investment returns:

  - FCA authorisation: As set out in the BVCA's response to the Pensions Investment Review, the proposed new requirement that pools would be required to be FCA-authorised investment management companies should help in ensuring that they have the right expertise and sufficient capacity to construct sophisticated and diversified investment portfolios including private capital fund investments.

  - Local targets mean "UK" for reporting purposes: Legislation should require pools to report against their UK-wide investment, rather than granular local investment targets. This would favour UK economic growth whilst embedding sufficient flexibility to reflect the range of circumstances and objectives of different local authorities, without precluding partner funds from requesting their pool aim to deliver more immediately local investments. We support the ambition that pools should continue to invest in a way that both prioritises returns and positively influences the regions in which they are based. Though we recognise the challenges in terms of setting defined targets – including definitions and the need to prioritise fiduciary duty – we welcome the proposed approach, which would require pools to work with funds to set a 'soft' target appropriate to their circumstances, but recommend that pools should be required to report on this on a UK-wide basis. The ability of Administering Authorities to engage with and to scrutinise the investment decisions of the pools is essential.

  - Absence of mandatory UK allocations: We are pleased to see the consultation does not include any mandatory UK allocation requirement, and hope that this will continue to be the approach as the Government progresses with its pensions review. Though we welcome initiatives designed to encourage and enable investment in both the UK and its regions, mandatory requirements risk de-prioritising scheme members' interests, denting scheme performance, distorting the market and creating asset bubbles.

- In addition to the Government's consultation proposals, the following parallel measures to reform the wider UK business growth investment ecosystem are needed to ensure the LGPS can invest in smaller funds, and therefore support national regional growth investment:

  - Expand the remit of the British Business Bank to cover growth equity funds: The BBB's remit should be extended to cover small UK-focused private equity growth strategies (accompanied by an increase in investment capital to allocate to this part of the market). There is a degree of consensus that the BBB should be able to invest in small growth equity funds, as well as venture, like the EIF used to in the UK and still does in the EU (as the EU sees the benefits to SME growth of this investment activity). This will bring scale and expertise that will help de-risk investment decisions about smaller growth equity funds for the LGPS pools (and potentially UK DC schemes and other investors). Industry feedback suggests that BBB cornerstone investments in smaller growth equity funds would be powerful in helping to crowd in further investment from LGPS pools, thereby growing the investment ecosystem and access for companies to growth finance in this segment of the market.

- Fund of funds: One option is for a Government-backed fund of funds programme to take larger cheques from LGPS pools which it could then deploy using its expertise into UK opportunities. This could perhaps be deployed through an ECF-style programme under which the BBB's LP interest would have less favourable terms than other LPs, in order to help crowd in UK pensions investment (DC and LGPS). Government could also support a larger, private sector-led fund of funds (or fund of funds programme) focused on UK SME investments, perhaps with BBB involvement e.g. as a cornerstone and/or some kind of advisory or pipeline providing role to build confidence amongst DC and LGPS.

- UK scheme inspired by France's Tibi scheme: The Government should also develop a programme inspired by France's Tibi scheme, which has pulled in around £20bn into private funds supporting the French tech ecosystem. There are a number of possible models, one of which could be to establish a body of experts to act as gatekeepers, using defined entry criteria, for a maintained marketplace of accredited private capital funds for LGPS and other UK investors that would build confidence and understanding whilst reducing cost. This would involve relatively limited Government resource and **the BVCA would be happy to explore this in more detail with officials.**

Introduction

Scale is pre-requisite but not the cause of private capital investment

Scale is necessary for LGPS or other investors to invest effectively in private capital. BVCA research shows that large global pension funds invest 16 times more capital in UK private capital funds than UK pension funds do. This lack of UK investment in the UK is perpetuated by insufficient scale amongst UK institutional investors including the LGPS funds, so the BVCA particularly welcomes the Chancellor's commitment to accelerating and improving LGPS pooling and establishing 'mega funds' in circumstances where pension schemes are not delivering greater diversification, improving performance, and increasing UK investment. Scale enables the right expertise, contacts, and the ability to develop in-house capabilities. The most relevant overseas comparison for the LGPS are the Canadian 'Maple 8', which report significant benefits of scale at around £44bn AUM. We welcome that the consultation recognises this, citing evidence from other nations, where larger, more consolidated pension schemes see significantly larger sums invested in private capital funds.

We should stress that scale is not the <u>only</u> factor in whether pension providers can and will diversify into private capital and UK growth companies. Further pooling also needs to be accompanied by the right conditions, focused on resource, structure and the wider business financing ecosystem. There is a danger that seeking scale as a way of cutting costs, rather than a means of boosting diversification and returns, may result in the LGPS making fewer, larger global (rather than UK) investments. This would be detrimental to smaller, regional funds that prioritise local solutions and help smaller regional businesses grow into national champions.

Nevertheless, we do believe scale is a pre-requisite for diversification into private capital and therefore broadly support the proposals for greater pooling.

The "ticket size" challenge

Investors in private capital funds often do not want their capital to form more than c.10% of a fund's total capital (note that private capital funds of all sizes are almost always closed-ended funds with a fixed size and lifespan (typically 10-15 years)), for risk pooling and diversification reasons. The precise concentration limit varies by fund, but 10% is a reasonable rule of thumb. As investors grow in size, there is pressure for the minimum amount they invest in any one fund (the "ticket size") to grow as well. This is because it can seem more economical to make a smaller number of large investments than it is to make a larger number of small investments.

The combination of the c.10% concentration limit and the pressure towards larger minimum ticket sizes means it can become more challenging for larger investors to invest in smaller private capital funds, unless those investors consciously structure themselves in a way that enables them to continue making smaller investments (e.g. by having dedicated teams managing smaller "pots" earmarked for this kind of investment, within the investor's total AUM). In the LGPS context in particular, there is significant concern amongst some of the BVCA's venture capital and growth equity fund members (based on current market experience) that increased pooling will in effect create much larger LGPS investors with higher minimum ticket sizes that will only invest in larger private capital funds (that typically have less UK-centric investment strategies).

The optimal size of smaller, more UK-centric private capital funds (which is based on the size of the smaller companies they invest in) is typically around £100-500m. This means that the maximum commitment any single investor will seek to make is typically around £10-50m. **It is critical for the Government to give determined, specific policy consideration to how LGPS pools can make investments of this size, even as they grow.**

The importance to UK economic growth of solving the "ticket size" challenge

It is clearly important for economic growth across the UK to solve this "ticket size" challenge and ensure that the LGPS retains its ability to invest in smaller private capital funds that support local economies, growth and jobs. **The BVCA has a range of current data and recent case studies from relevant member firms that demonstrate the economic impact and strong returns from smaller private capital funds.**

Smaller private capital funds are the archetype of the "active ownership" model of private capital investment, and drive the growth of smaller UK businesses into local, regional and national champions. They also form a critical part of the UK's business growth and investment ecosystem, providing a pipeline of investment opportunities for larger funds and public markets.

Venture capital funds, which make equity investments in high growth start-ups, typically (not always) fall within this bracket. They are important for the UK economy because they drive innovation in important areas (AI, biotech, life sciences, cleantech etc.) and create very fast-growing businesses that deliver jobs and offer technological solutions to business, social and environmental challenges.

Growth equity funds also fall within this bracket. These funds also make equity investments - often with no or limited acquisition debt - in more established small businesses. They do this in order to super-charge those companies' growth by: (i) providing injections of more capital via equity (most of which is invested in the business rather than being used to "buy out" existing shareholders, who are often existing management that stay on to help grow the company); and (ii) providing business growth support and expertise through "active ownership", sometimes through a large minority stake but very often by majority ownership. The investment strategy of these funds is to increase revenue, jobs, productivity, sustainability performance and so on, such that the company can be sold at high multiple of the initial investment to a larger investor or the public markets. Growth equity funds will accelerate the growth of small local companies towards them becoming regional, national and international champions.

How to solve the ticket size challenge

Fortunately, the ticket-size challenge is surmountable, as proven by pension schemes in other parts of the world. Despite the size of individual overseas schemes being larger, these and other overseas pension schemes continue to execute sophisticated and diversified private capital investment programmes that include allocations to smaller funds. We have made a number of recommendations on how this can be achieved in the UK context both above, in the Executive Summary, and below in our answers to specific questions posed in the consultation.

<u>Consultation question responses</u>

Below we have responded to selected questions where we think the private capital perspective may be useful.

Chapter 2: LGPS pooling

Question 1: Do you agree that all pools should be required to meet the minimum standards of pooling set out above?

Overall, it is positive to see that the proposals are moving in the right direction. We recognise the important relationship between scale and ensuring the right expertise and structures are in place that will enable investment in complex private capital projects that are so essential to UK growth.

Pooling has had some success in promoting LGPS investment in UK productive assets. The LGPS has around 15% allocation to private markets and 6% in 'private equity[1]'. However, the UK scheme as a whole has a combined value of over £400bn, putting it amongst the largest pools of capital in the world. Asset owners of

[1] https://lgpsboard.org/index.php/asset-allocation

that size often have around 20-30% invested in private markets. This discrepancy arises in part because the pooling project is incomplete - it covers less than 50% of assets, remains fragmented across eight pools and 86 funds, has not always been structured in a way that facilitates private capital investment.

We support the proposed operating model, which would see AAs being responsible for setting investment strategy, and pools taking responsibility for execution.

We do not have especially strong views on how investment advice is received, though it is our view that the more complex investments, such as private equity, do require investors to have the right knowledge and, often, contacts. A number of pools have already taken significant steps into private capital investments, and have done so successfully. However, for those that do not, we think that the expertise and contacts need to be built over time – we are realistic in terms of any assumptions that this can happen over a short time frame. The proposals need to ensure that the right governance knowledge are available; and that the need to have proper advice on those investments form an important part of the future landscape, especially in those areas where they are not yet established.

We strongly support the proposed requirement for all pools to be established as FCA-authorised investment management companies. BVCA members' experience suggests that pools with an FCA-regulated asset manager are better able to execute effective private markets programmes. This enables the creation of a centre of investment expertise for partner funds to gain access to range of local, regional and global private capital opportunities. That relationship experience and local expertise can often be very important in accessing UK investment opportunities.

Question 2: Do you agree that the investment strategy set by the administering authority should include high-level investment objectives, and optionally, a high-level strategic asset allocation, with all implementation activity delegated to the pool?

We largely support the proposed model, for the reasons set out above.

We believe it is important the funds have the ability to influence the execution of the strategy. Typically, LGPS funds have looked to support projects in the areas in which they are based. Though we recognise that not all investments that will benefit a location are necessarily based within in it, it is our view that the local knowledge that AAs have, and the lack of growth we see in regional areas, makes this an important aspect that should be retained. In additional to the suggestion above, and as the consultation paper suggests, we strongly support measures that enable AAs to set out investment objectives, and to ensure representation within the pool to enable them to monitor and scrutinse whether these objectives are being met.

Question 3: Do you agree that an investment strategy on this basis would be sufficient to meet the administering authority's fiduciary duty?

We think that this is consistent with the fiduciary duty and recommend the ability to meet contractual pension obligations should remain a priority.

Question 4: What are your views on the proposed template for strategic asset allocation in the investment strategy statement?

We think the template is . However, it would be very helpful to provide further guidance on determining whether an investment in the private equity category should be recorded as venture capital, growth equity, buyout or "other". We recommend the definitions suggested in the Pensions and Private Capital Expert Panel Interim Report (pp.91-92).

Question 6: Do you agree that all pools should be established as investment management companies authorised by the FCA, and authorised to provide relevant advice?

For the reasons set out in Question 1, we support this proposal.

Question 7: Do you agree that administering authorities should be required to transfer all listed assets into pooled vehicles managed by their pool company?

We believe this is consistent with the wider policy proposal, and so are supportive.

Question 8: Do you agree that administering authorities should be required to transfer legacy illiquid investments to the management of the pool?

We think that control of the assets should be handed over, though recognise that transferring ownership may be costly and unnecessary.

Question 10: Do you have views on the indicative timeline for implementation, with pools adopting the proposed characteristics and pooling being complete by March 2026?

In terms of the practicalities, we recognise that it is for the LGPS and pools to comment on whether a short timeline is achievable.

We would, however, note concerns about the possibility of the transition period being prolonged. Clearly the deadline and the preparations for transfers will result in most other matters being sidelined and effectively mean that funds will no longer be making long-term investment decisions. If this transition was to take place over a number of years, there is a strong likelihood that current investment levels by the LGPS will decline. This would be detrimental to local economies and to the scheme itself, and so needs to be considered alongside the practical implementation issues when setting timelines.

Other developments

Question 11: What scope is there to increase collaboration between pools, including the sharing of specialisms or specific local expertise? Are there any barriers to such collaboration?

- In addition to the Government's consultation proposals, the following parallel measures to reform the wider UK business growth investment ecosystem are needed to ensure the LGPS can invest in smaller funds, and therefore support national and regional growth through investment:
    - Expand the remit of the British Business Bank to cover growth equity funds: The BBB's remit should be extended to cover small UK-focused private equity growth strategies (accompanied by an increase in investment capital to allocate to this part of the market). There is a degree of consensus that the BBB should be able to invest in small growth equity

funds, as well as venture, like the EIF used to in the UK and still does in the EU (as the EU sees the benefits to SME growth of this investment activity). This will bring scale and expertise that will help de-risk investment decisions about smaller growth equity funds for the LGPS pools (and potentially UK DC schemes and other investors). Industry feedback suggests that BBB cornerstone investments in smaller growth equity funds would be powerful in helping to crowd in further investment from LGPS pools thereby growing the investment ecosystem and access for companies to growth finance in this segment of the market.

- Fund of funds: One option under consideration is for a Government-backed fund of funds programme to take larger cheques from LGPS pools which it could then deploy using its expertise into UK opportunities. This could perhaps be deployed through an ECF-style programme under which the BBB's LP interest would have less favourable terms than other LPs, in order to help crowd in UK pensions investment (DC and LGPS). Government could also support a larger, private sector-led fund of funds (or fund of funds programme) focused on UK SME investments, perhaps with BBB involvement e.g. as a cornerstone and/or some kind of advisory or pipeline providing role to build confidence amongst DC and LGPS.

- UK scheme inspired by France's Tibi scheme: The Government should also develop a programme inspired by France's Tibi scheme, which has pulled in around £20bn into private funds supporting the French tech ecosystem. There are a number of possible models, one of which could be to establish a body of experts to act as gatekeepers, using defined entry criteria, for a maintained marketplace of accredited private capital funds for LGPS and other UK investors that would build confidence and understanding whilst reducing cost. This would involve relatively limited Government resource and **the BVCA would be happy to explore this in more detail with officials.**

Chapter 3: Local investment

Question 13: What are your views on the appropriate definition of 'local investment' for reporting purposes ?

We support the ambition that pools should continue to invest in a way that both prioritises returns and positively influences the regions in which they are based. Though we recognise the challenges in terms of setting mandatory allocations – including definitions and the need to prioritise fiduciary duty – we welcome the proposed approach, which would require pools to work with funds to set a 'soft' target appropriate to their circumstances, but recommend that pools should be required to report on this on a UK-wide basis. This is due to the variety of circumstances of different regions the pools might cover. Rural areas, for example, may be more challenging than urban areas when it comes to finding attractive local investment opportunities. It should also be acknowledged that the benefits of an investment can have a much wider reach than the immediate location in which it was made. For example, this could be through job creation or access to alternative energy sources.

However, we hope that the pools will work with AAs closely both in terms of executing strategic asset allocation, and in providing information on the levels of investment in their respective areas. Nevertheless, we recognise that implementing such arrangements on a mandatory basis would be difficult, and therefore believe pools should be asked to report only at UK-level, which is consistent with the proposals previously consulted on.

We are pleased to see the consultation does not include any mandatory UK allocation requirement, and hope that this will continue to be the approach as the Government progresses with its pensions review. Though we welcome initiatives designed to encourage and enable investment in both the UK and its regions, mandatory requirements risk de-prioritising scheme members' interests, denting scheme performance, distorting the market and creating asset bubbles.

Question 14: Do you agree that administering authorities should work with their Combined Authority, Mayoral Combined Authority, Combined County Authority, Corporate Joint Committee or with local authorities in areas where these do not exist, to identify suitable local investment opportunities, and to have regard to local growth plans and local growth priorities in setting their investment strategy? How would you envisage your pool would seek to achieve this?

We support this proposal because it is our strong view that the relationship between AAs and their regions needs to be retained. The place-based element of LGPS fund investment has been relatively successful to date and can point to a number of examples of regional fund managers working with LGPS funds to support local projects.

So, if the proposals are progressed, the proposals need to ensure that the ability of AAs to influence, direct, and monitor place-based investments are retained.

We support the measures set out in the consultation that are aimed at retaining this connection, including mandating consultation with local stakeholders with a view to setting a 'soft' target on local investments, representation on AAs on governance boards, and the right to set strategic asset allocation.

Question 15: Do you agree that administering authorities should set out their objectives on local investment, including a target range in their investment strategy statement?

As set out in Question 14, we support this proposal.

Question 16: Do you agree that pools should be required to develop the capability to carry out due diligence on local investment opportunities and to manage such investments?

It is essential that the pools have the expertise and capacity to fully execute and monitor private capital investments. Clearly a private markets programme requires particular expertise, resource, and often the right contacts to ensure access to the best opportunities. This is particularly the case if there is to be a focus on UK investments or place-based investments. Anecdotal evidence from some of our members suggests that some of the pooling that has already occurred resulted in investments teams of a similar size, though with significantly larger assets under management.

A key benefit of scale is that that the concentration of expertise become more economical. It is therefore essential that the proposed operating model sets a high bar for investment expertise and capability, and that an undue focus on cutting costs is avoided. Teams that do not have the expertise or capacity may be inadvertently pushed towards 'safer' investments, or larger funds. As set out in our introduction, we believe that a failure to invest in a range of private capital opportunities will impact both the diversification of returns, and also the ability of the scheme to support regional growth.

In addition, we note our concerns that such expertise and contacts are unlikely to be developed quickly. We support the long-term target of pools developing significant in-house expertise, but acknowledge that, in the short to medium term, they may be dependent on fund managers in sourcing and executing the best opportunities.

Question 17: Do you agree that administering authorities should report on their local investments and their impact in their annual reports? What should be included in this reporting?

We would agree that this is appropriate in order to allow AAs, stakeholders, and member of the scheme to understand its impact.

Feedback from a number of DC and private sector DB schemes we work with also notes the power of being able to demonstrate 'real world' impact of pension schemes. We believe that this can play an important role in pension investment and encouraging a place-based approach.

Chapter 4: Governance of funds and pools

Fund governance (Questions 18 – 26):

We don't have detailed views on this section, but strongly support there being high standards of knowledge and governance for those overseeing large pools of capital. This will be an important driver of greater diversification and improved investment returns, which in turn will lead to more private capital investments and UK economic growth.

Pool governance

Question 27: Do you agree that pool company boards should include one or two shareholder representatives?

We support this proposal. As set out in previous questions, we are concerned about the ability of funds to ensure the pools continue the key role in facilitating local growth opportunities. Alongside the other measures we have set out, we believe this is an important means of maintaining a connection with regions.

Question 29: Do you agree that pools should report consistently and with greater transparency including on performance and costs? What metrics do you think would be beneficial to include in this reporting?

We agree on the reporting of performance and costs. However, given the commentary in other parts of the consultation paper regarding excessive reporting requirements, it may be helpful to clarify who the intended audience is – clearly a professional target audience will have a different use for the data than, for example, scheme members.

In general we would note the importance of reporting performance net of costs (albeit, it is reasonable to also report costs separately).

If progressed, we believe there should be in-depth consideration and guidance of what is meant by costs. In the UK DC context, where there are existing expectations on cost disclosure, there remains a great deal of uncertainty on how to report investment costs. For example, the issue of 'look through' of funds continues to be uncertain. Further examples of the challenges of cost reporting for DC schemes are set out in the report of the Pensions & Private Capital Expert Panel. These issues are particularly challenging in relation to private capital investments, where like-for-like comparisons with public market investments are often sought, but can mislead by highlighting short-term cost considerations over longer-term value (which private capital fund investments seek to generate).

We are concerned that an undue focus on cost would be detrimental to the LGPS. We support the transparency on investment performance and costs, but would recommend ensuring that there is clear guidance for pools on how to report, and context given in the data when reported.

The BVCA would be delighted to share further insights from our engagement with the pensions industry and BVCA members on this topic through further discussion with officials.