7 October 2013

Chris Megainey
Department for Communities and Local Government
Eland House
Bressenden Place
London
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Dear Mr Megainey

Issue 162: Investment powers of local authorities under the Local Government Pension Scheme

The role of the Financial Markets Law Committee (the "**FMLC**" or the "**Committee**") is to identify issues of legal uncertainty, or misunderstanding, present and future, in the framework of the wholesale financial markets which give rise to material risks, and to consider how such issues should be addressed.

The FMLC would like to draw the attention of the Department for Communities and Local Government ("**DCLG**") to an uncertainty in the legislation governing the investment powers of a local authority in relation to the pension fund it administers under the Local Government Pension Scheme (the "**LGPS**"). This legal uncertainty poses a risk for both the LGPS and its constituent local authority funds and also for any financial institutions with which they contract.

The uncertainty arises under the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009 (the "**Regulations**"), which govern the investment powers of a local authority in relation to the pension fund it administers under the LGPS, and in particular under Regulation 3.

Regulation 11(3) of the Regulations requires a local authority to "*invest, in accordance with its investment policy, any fund money that is not needed immediately to make payments from the fund*". In execution of this statutory duty, a local authority will want to invest in a variety of financial instruments in order to ensure the optimum return for its pension fund.

These investments, however, give rise to various forms of market risk—in particular interest rate, currency exchange rate and inflation-related risks. In order properly to manage those risks, the relevant local authority will want to hedge, where appropriate—and the most efficient hedging typically involves use of a derivative such as a swap, forward or option. It is therefore important that the local authority has clarity as to the extent of its power to hedge in connection with its investment powers. It is equally important for any investment manager appointed by the local authority to understand the scope of its delegated authority and for each counterparty to a hedging transaction with the local authority (or its investment manager) in relation to the local authority pension fund to be sure that the transaction is within the powers of the local authority under the Regulations.

Regulation 3(1) provides that "*'investment' and related expressions have their normal meaning*", although it goes on to specify things that count as investments for the purposes of the Regulations although they might not otherwise do so, and to exclude things which might otherwise count. For example, Regulation 3(3) provides that a contract entered into in the course of dealing in financial futures or traded options is an investment.

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There is uncertainty as to what constitutes the "*normal meaning*" of "*investment*" and also as to the intended scope of "*financial futures*" ("*traded options*" is given a fairly clear definition).

As to the normal meaning of "*investment*", it is not clear from case law that this term includes derivatives, particularly where the derivative is entered into for the purpose of hedging or managing risk. A traditional view of investment is that it involves the laying out of money in the hope or expectation (not necessarily guaranteed) of a return. A transaction entered into to hedge interest rate risk, such as an interest rate swap, would not appear to fall within this definition. Similarly, while the purchase of an option may appear to fall within this definition of an investment, the sale of an option clearly does not.

It is perhaps for this reason that Regulation 3(3) includes two specific examples of derivatives as permitted investments—namely, financial futures and traded options. A traded option is, in fact, defined to mean "*an option quoted on a recognised stock exchange or on the London International Financial Futures and Options Exchange*". This definition is reasonably clear and excludes an over-the-counter ("**OTC**") interest rate, currency or inflation-related option.

Unhelpfully, the term "*financial futures*" is not defined. In commercial language, however, the term is used exclusively to refer to exchange-traded contracts. Accordingly, neither of the specific terms relating to derivatives used in Regulation 3(3) appears to cover OTC transactions, yet the bulk of interest rate, currency and inflation-related hedging occurs OTC according to figures published by the Bank for International Settlements (BIS) in Basel.

It appears that many local authorities believe that they have the power to enter into certain OTC transactions, such as forward foreign exchange contracts, to manage risks associated with their funds, provided that they do so for a hedging and not a speculative purpose. One local authority, for example, says the following, in its most recent published report for its pension fund, about its use of derivatives:

> *The fund uses derivative financial instruments to manage its exposure to specific risks arising from its investment activities. The fund does not hold derivatives for speculative purposes.*
>
> *Derivative contract assets are fair valued at bid prices and liabilities are fair valued at offer prices. Changes in the fair value of derivative contracts are included in change in market value.*
>
> *The value of futures contracts is determined using exchange prices at the reporting date. Amounts due from or owed to the broker are the amounts outstanding in respect of the initial margin and variation margin.*
>
> *The future value of forward currency contracts is based on market forward exchange rates at the year-end date and determined as the gain or loss that would arise if the outstanding contract were matched at the year-end with an equal and opposite contract.*

The foregoing seems sensible and prudent, and we quote this merely to indicate that this local authority clearly considers (as do many other local authorities) that forward currency contracts are within the scope of its investment power under the Regulations. This is not clear, however, based on the text of the Regulations in light of the analysis above. As to the difference between hedging and speculation, the Court of Appeal has recently highlighted in *Standard Chartered Bank v Ceylon Petroleum Corp* [2012] EWCA Civ 1049 (at paragraph 36) the difficulty of basing a test of the legal capacity of an entity on that distinction.

In summary, it is unclear that a local authority participating in the LGPS has the power to enter into derivatives, other than financial futures or traded options, for the purpose of managing risk. As a consequence, some local authorities refrain from using derivatives to manage risk, which potentially exposes their pension funds to unnecessary risk, while other local authorities have apparently entered into OTC hedging transactions that could, if challenged, be found to be outside their powers. This raises a clear risk of potential economic loss for both the local authority pension fund and the counterparty, as well as the risk of the systemic impact of a loss of market confidence in this sector.

There are various ways in which this uncertainty could be removed. One way would be to add additional categories of derivatives to the list of permitted investments set out in Regulation 3. A better approach may be for this aspect of the LGPS investment regulations to be modelled on the investment regulations applicable to private sector occupational pension schemes, the Occupational Pension Schemes (Investment) Regulations 2005 (the "**OPSI Regulations**"). The OPSI Regulations are considered to give the trustees of occupational pension schemes sufficiently wide investment powers to enable them to invest in derivatives and other financial instruments for the purposes of managing risks.

The FMLC is not aware of any public policy reason for restricting the hedging powers of a local authority in relation to its pension fund more than the hedging powers of a trustee of an occupational pension scheme. In the absence of such a reason, amending the Regulations to align them with the OPSI Regulations would, in the view of the Committee, give sufficient legal certainty to the hedging power of a local authority in relation to its pension fund under the LGPS.

The Committee understands that the DCLG is aware of this issue and that it intends to review the Regulations more widely in the future. The Committee would support a review of the Regulations and would encourage DCLG to propose amendments to the Regulations which would remove the uncertainty. Furthermore, the Committee would be grateful if DCLG could provide it with an update on the progress of any regulatory developments on this front.

I and Members of the Committee would be delighted to meet with you to discuss the issues raised in this letter. Please do not hesitate to contact me to arrange such a meeting or should you require further information or assistance.

Yours sincerely

Joanna Perkins

Joanna Perkins
FMLC Director