Briefing note

Levelling Up and the role of the LGPS

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HM Government published its long-awaited white paper on Levelling Up on 2 February 2022. Here we summarise the main proposals and key implications for pension funds.

Policy background and overview

The UK has wider geographic disparities of wealth, education and health than many other developed economies. These lead to lower economic growth and poorer quality of life for many and have contributed to increased political and social instability in recent years. The Levelling Up initiative aims to close the gap between those areas which are flourishing and those which are not, whilst continuing to capitalise on areas of strength.

The policy proposals are based on research which shows that regions thrive economically and socially when an appropriate blend of six sources of capital exist:

- Physical capital, such as infrastructure and housing
- Human capital, ie a healthy and skilled workforce
- Intangible capital, driven by high levels of innovation
- Financial capital, readily available to support business growth
- Social capital, ie strong communities and high levels of trust within society
- Institutional capital, such as strong local leadership.

Levelling Up sets ambitious medium-term (2030) goals to: (1) boost productivity, pay, jobs and living standards by growing the private sector, (2) spread opportunities and improve public services, (3) restore a sense of community, and (4) empower local leaders and communities with a focus on areas where they are weakest.

The white paper sets out a broad programme of policy proposals and existing initiatives in areas such:

- Transport and digital infrastructure, such as gigabit-capable broadband and 4G mobile networks
- Research and development, such as new innovation accelerators in Manchester, Glasgow and the West Midlands
- Education, including enhancements to both schools and vocational skills training
- Urban regeneration, with a particular focus on 20 "left behind" towns and cities

- Housing, increasing both the supply and quality of social and private housing
- Tax policy, such as new freeports, enterprise zones and CapEx deductibles
- Wider and deeper local devolution, coupled with stronger accountability.

Financing the Levelling Up programme

Substantial capital investment will be required to deliver these improvements. Some will be publicly funded in the form of major CapEx programmes such as the Integrated Rail Plan (£96bn) and "pump priming" investments such as a new generation of Regional Investment Funds (£3bn) managed by the British Business Bank. It is clear however that the initiative depends on mobilising significant amounts of private sector capital.

The role of LGPS funds

The white paper is short on details about how Levelling Up will be financed, but UK pension funds in general, and LGPS funds in particular, are identified as an "under-utilised" source of potential capital. It proposes requiring LGPS funds to publish plans for increasing local investment, including setting an ambition of up to 5% of assets invested in projects that support local areas.

Subsequent clarification provided by the Department for Levelling-Up, Housing and Communities indicates that:

- "Local" means anywhere in the UK
- Incremental investment is required, and 5% of assets is the minimum required, not a maximum
- There are no specific restrictions on the range of qualifying investments, though it is expected they will include infrastructure, urban regeneration schemes, housing and SME finance.

We disagree with the assertion that the capital controlled by LGPS funds is under-utilised. Most funds are near fully invested in a wide range of risk assets and aim to generate the investment returns needed to pay benefits to pension scheme members while maintaining employer contributions at affordable levels.

Defining local to cover the whole of the UK is helpful, though consideration will need to be given to avoiding London and the South East absorbing most of the new investment if reliance is placed solely on market mechanisms to determine the allocation of capital. We note however that many funds already invest a significant proportion of capital in the UK. Requiring such funds to invest an additional 5% of assets could reduce portfolio diversification and put at risk investment outcomes for scheme members.

One key challenge LGPS funds will face is avoiding potential conflicts with their primary purpose of paying pensions. This does not preclude local investments, but LGPS funds are required to ensure that the prospective risk and returns of such investments are at least as attractive as those available elsewhere. Making local investments which do not meet this requirement could put funds in breach of their fiduciary obligations to scheme members.

Nonetheless we do believe that LGPS funds, with their long-term investment horizons and strong local knowledge and networks, are well placed to play a key role here. It helps that many of the anticipated investment opportunities are in areas that have been of considerable interest to LGPS funds for many years and which fit well within their overall investment strategies.

Other sources of institutional capital

We also believe there are other sources of long-term capital which could be mobilised to support Levelling Up. They include corporate defined benefit and defined contribution pension schemes and insurance funds. In aggregate they represent a pool of capital many times larger than the LGPS. Obstacles exist to investing in Levelling Up opportunities. Some are specific to individual schemes: illiquid investments in infrastructure may not be suitable for a corporate defined benefit pension scheme seeking a buyout in the next few years for example. But many are constrained by regulation: rules on eligible assets and charge caps in the case of defined contribution schemes and solvency capital requirements for insurance funds. We believe the UK Government should revisit current regulations with a view to facilitating investment in Levelling Up projects.

The role of Government

We further believe the Government has a role to play in addressing one of the key challenges that have faced institutions investing in local projects in recent years: increasing the pipeline of attractive, new investment opportunities. Steps that it could take include:

- Streamlining the planning process for new infrastructure and housing developments
- Selective de-risking of particularly large or complex infrastructure or regeneration projects
- Upgrading technical and commercial skills, and promoting research, especially in regions where they are weak
- Supporting investment managers with seed funding as they develop the capabilities, bandwidth and track record needed to build institutional scale portfolios of local investments.

Although there is a clear imperative, Levelling Up will be no quick fix. Many of the investments needed will take time to develop and implement, and even longer to reap the benefits. Significant volumes of capital will be required, but the initiative will also require a high degree of patience and persistence from all those involved.

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