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# Localising pension fund investments

Engaging with stakeholders,  
overcoming the barriers

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## Executive summary

The UK has vast inequalities in outcomes between different localities and regions, resulting in part from a bias in public and private investment towards already-affluent areas. Since the 2008 financial crisis and subsequent recession, policy-makers have looked to pension funds to contribute to an investment-led economic recovery, focused on, among other things, supporting a more geographically balanced economy.

However, there have been few substantive policy changes to support this agenda, and little attention given to **the prospect of pension funds localising their investment strategies**, despite (very large) local authority pension funds being central to elite discourse in this regard. But we cannot rely solely on local authority funds to lead this agenda; **the prospect of private sector pension funds contributing to localisation in investment practice** should also be explored.

The project presented in this report encompassed a series of **seminars with stakeholders and experts in three English city-regions**: Manchester, Sheffield and Birmingham. Participants included local government officials, economists, local business and civil society leaders, and finance and investment professionals (including pensions industry representatives).

The stakeholder discussions were informed by **previous SPERI research** in this area. This research has demonstrated the shift away from listed equities among all defined benefit pension funds. But local authority funds have not mirrored the private sector's move into bonds, and instead have demonstrated stronger interest in 'alternative' assets such as infrastructure, albeit from a very low base. Overall, we have very little reliable information on alternative investment allocations, the appetite for local investment, and investment practices in defined contribution provision.

It is possible to identify a number of key points which were consistently voiced in the seminars:

- **Pension funds' first duty must always be to scheme members**, and delivering the benefits they have been promised. Local authority funds are part of the public sector, but made up of private money belonging to individual members.
- The growing interest in alternative investments may be in order to mitigate risks associated with conventional assets, rather than demonstrating an appetite for long-term and risky investments.
- Pension funds will always be **unlikely to be attracted to very early-stage investments**, including in infrastructure. The risks involved in early-stage investments should be shouldered directly by the public sector, enabling pension funds to play a crucial role as secondary investors or lenders. There is support for a greater proliferation of debt-based products that allow pension funds to provide credit for local projects.
- There are concerns about the way that complex and expensive **intermediation processes incentivise short-termist investments** in conventional assets, which in turn disadvantages poorer localities.
- While there are concerns about over-intermediation in conventional asset management, there are few mechanisms for introducing institutional investors to *local* investment opportunities. **Local authorities, and metro-mayors, could play an important role in mediating between pension funds and potential investees in local economies.**
- Most participants recognised that greater scale makes riskier investments easier to mitigate, but many expressed concern that **the government's focus on increase the scale of pension funds, through pooling initiatives, risks further detaching investment strategies from local economies.**
- Local investment may, however, expose scheme members to excessive risks. There are concerns around **the 'double exposure' associated with local investments**, whereby a local economic downturn which affects local firms might also be reflected in reduced returns on pension investments. Reciprocal arrangements between funds based in different areas may mitigate this risk.

- We need **more information about the preferences of scheme members in relation to local investments**, and particularly whether they would be willing to risk lower returns in order to support local economic development through their pensions saving.
- **Localisation may be more achievable within defined contribution funds**, partly because the individualised nature of funds meant members should have more influence over investment strategies. Large defined contribution funds such as NEST may represent an opportunity in this regard.
- However, most seminar participants acknowledged they had little or no knowledge of defined contribution investment decisions and processes.

Pension funds are right to be concerned about the 'double exposure' associated with local investments. Yet the financial crisis demonstrates that the concentration of investment in London-centred capital markets is riskier than previously assumed. Even if it is unwise for a single pension fund to be exposed to a limited range of local economies, **it is not unreasonable to expect a more even distribution of pension fund capital allocation by geography across the UK.**

Of course, this is not to discount the impact of **population ageing** on defined benefit pension funds, including local authority funds. This underlines the **need to consider the relationship between the new, younger automatic enrolment landscape and the prospect of localising pension fund investment strategies.**

The project has informed a number of **suggestions for policy and practice**. In terms of **central government**, the most urgent priority is the establishment of a genuine, place-based public investment programme by the Treasury, which pension funds can cohere around. Greater thought is required, by the Ministry of Housing, Communities and Local Government, about the implications of pooling for locally-oriented investment strategies among local authority pension funds. Both departments need to consider whether metro-mayors have sufficient powers and capacity to contribute to the localisation agenda, and the Department for Business, Energy and Industrial Strategy needs to consider whether the British Business Bank could engage systematically with pension funds.

The Department for Work and Pensions needs to ensure that pensions regulation (such as valuation cycles) does not discourage local investments, reconsider whether the National Employment Savings Trust (NEST) can further localise its investment strategy, and explore how the barriers to collective defined contribution provision can be overcome.

In terms of **local government**, there is scope for metro-mayors and combined authorities to think more strategically about the operation of local authority pension funds. Mayors should also be looking to mediate between private sector pension funds and potential investees in the local economy, and if necessary push for greater devolution of fiscal powers to fulfil this function effectively.

**Large employers** need to take their role as local anchor institutions seriously – and this role should be reflected in their pensions practice. They should also seek to survey members more extensively on investment preferences – an initiative NEST could also undertake. More generally, all relevant stakeholders (including trade unions) should consider whether local investment strategies might be best realised away from the formal processes of pensions saving.

- Clearly, further research is necessary before firm recommendations can be advanced. Priorities include:
- Developing a 'census' of the pensions capital created in the private sector across different localities and regions, and how it tends to be invested.
- Understanding the investment strategies of large defined contribution scheme providers.
- It will be vital also to explore the capacity of local authorities to engage with private sector pension funds.

## Introduction and background

The investment orientation of UK pension funds has been a recurrent – if rather unusual – trope within elite policy discourse since the financial crisis. How and where pension funds invest sits at the intersection of three main economic problems:

- Vast inequalities in outcomes between different localities and regions;
- Manufacturing decline and the economy's over-reliance on the finance sector;
- Sluggish productivity growth, arising at least to some extent from low investment.

Given the vast size of the UK's defined benefit pension funds, it is perhaps no surprise that policy-makers have looked to funds to contribute to efforts to enable economic recovery, and 'rebalance' the economy in geographical and sectoral terms. Assets in UK pension funds are equivalent to more than 120 per cent of UK GDP; within this, local authority funds hold assets worth more than £200 billion. The perceived austerity imperative meant that private (or, in the case of some pension funds, pseudo-private) rather than public investment had to take the greatest strain of this agenda.

However, business investment in the UK is chronically low.<sup>1</sup> Pension funds are not culpable for under-investment, since their capital is, by definition, invested. But their investment practices, many argue, embody the same short-termist tendencies that are identifiable in the corporate sector.<sup>2</sup> This means they are averse to taking on, or less able to take on, the very long-term, large-scale and uncertain investments that tend to have greatest impact.

Pension funds therefore featured in HM Treasury's recent Patient Capital Review<sup>3</sup>, although the regulatory reforms recommended were rather limited, amounting to clarification on statutory guidance by the Pensions Regulator. Before that, pension funds had also featured in the Department for Business, Innovation and Skills' (now subsumed into the Department for Business, Energy and Industrial Strategy) Kay Review into equity markets and short-termism. But the finding that there were weaknesses in the investment chain related to pension fund capital was largely overlooked by the then coalition government.<sup>4</sup>

The coalition and Conservative governments have preferred to 'nudge' pension funds into making long-term investments, particularly into infrastructure. Voluntary initiatives such as the Pensions Infrastructure Platform (PIP), established by the National Association of Pension Funds (now the Pensions and Lifetime Savings Association) were designed to align with the coalition government's national infrastructure plan.<sup>5</sup> Central government plans – or, more precisely, ambitions – for infrastructure generally involve investing more in disadvantaged regions rather than London and the South East (where *public* infrastructure investment is concentrated).<sup>6</sup> In general, however, the notion that pension funds may *localise* their investment strategies, investing more in the local economies in which their capital is created (by employee savings), has not been a central part of policy initiatives in recent years.

As such, **the prospect of pension funds localising their investment strategies**, is one of the two main concerns of this project underpinning this report. This would include investment in local infrastructure projects, but not exclusively. The role that devolution in the English regions – particularly the creation of metro-mayors within city-regions – may play in this is also a key issue explored here.

1 Analysis of Gross Fixed Capital Formation data from the World Bank (available at <http://data.worldbank.org/indicator/NE.GDI.FTOT.ZS>) and OECD data on investment by sector (available at <https://data.oecd.org/gdp/investment-by-sector.htm>) shows that Italy had the lowest share of business investment across the G7 in 2015 at 8.9% of GDP followed by the UK at 9.4% of GDP.

2 Woolley, Paul (2010) 'Why are financial markets so inefficient and exploitative – and a suggested remedy', in Adair Turner *et al*, *The Future of Finance*, available at <http://www.lse.ac.uk/fmg/assets/documents/paul-woolley-centre/articles-of-general-interest/future-of-finance-chapter-3.pdf>.

3 See <https://www.gov.uk/government/publications/patient-capital-review>.

4 See <https://www.gov.uk/government/publications/kay-review-of-uk-equity-markets-and-long-term-decision-making-implementation-progress-report>.

5 See <http://www.pipfunds.co.uk/>.

6 Berry, Craig *et al* (2015) *Public Infrastructure Investment and Business Activity in the English Regions*, available at <https://speri.dept.shef.ac.uk/wp-content/uploads/2015/08/SPERI-Brief-No.15-Public-infrastructure-investment-business-activity-in-the-English-regions.pdf>.

It is worth noting, however, that it is specifically *local authority* pension funds that have already, implicitly, been at the heart of the rebalancing agenda. Most participants in the PIP are local authority funds. The coalition government made explicit its intentions regarding local authority funds, when the Department for Communities and Local Government (now the Ministry of Housing, Communities and Local Government) lifted restrictions on private equity investments in local authority funds.<sup>7</sup> This agenda was substantially advanced by plans for 'pooling' among all funds to create a much smaller number of funds.<sup>8</sup> There have also been related projects involving academics, civil society and local authority pension funds – but localisation in this sphere has been very small scale, and focused almost exclusively on housing.<sup>9</sup>

Of course, the link between local authority pension funds and localised pensions investment is a deceptive one. Some funds, notably the Greater Manchester Pension Fund, have begun to demonstrate an appetite for, and emerging track record in, local investments. In general, however, pension funds are invested for the benefit of scheme members, and there are few reasons to believe that, other things being equal, local authority employees have a stronger interest in local investments than other workers within the local economy.

It is for this reason that the second main concern of this project is **the prospect of private sector pension funds in particular contributing to localisation**. However, it has to be acknowledged that pensions saving in the private sector has, in recent years, become rather rare, as schemes close to new members or new accruals, and employers within fast-growing service industries have operated with no obligation or even expectation that they will facilitate pensions saving among their staff.

This has begun to change, due to legislation supported by successive governments to automatically enrol millions of 'under-pensioned' workers into workplace pension schemes. At the same time, however, private sector provision is becoming increasingly dominated by individualised defined contribution schemes, rather than collectivised defined benefit schemes. The government's own default provider, the National Employment Savings Trust (NEST), operates on a defined contribution model.

It is clear that local authority pension funds cannot alone shoulder the burden of localising pension fund investments. But there may still be a role for local government, especially in its new guise, in facilitating localisation within private sector pensions investment. Whether mayoral offices have the powers, resources and expertise to take on this challenge remains to be seen.

## This project

This project, generously funded by the Barrow Cadbury Trust, aimed to engage stakeholders and experts on pension investments based in three English cities: Manchester, Sheffield and Birmingham. It benefited hugely from partnerships with the Greater Manchester Pension Fund, the All-Party Parliamentary Group on Local Authority Pension Funds and Birmingham City Council, respectively, in arranging seminars in each city in late 2017 and early 2018. We are particularly grateful to Kieran Quinn and Andy Rowe in Manchester, and Clive Betts MP in Sheffield, for their support.

Sadly, Kieran Quinn (then leader of Tameside Metropolitan Borough Council and Chair of the Greater Manchester Pension Fund) died during the course of this project. This report is therefore dedicated to Kieran, and his pioneering work on pension fund investments in Greater Manchester. The project also benefited substantially from the support of Tom Hunt at SPERI, in organising and chairing the seminars.

The seminars benefited from the participation of a large number of stakeholders and experts, including:

- Local government development and finance officials, including representatives of combined authorities and mayoral offices;
- Economists and other public policy experts;
- Local business leaders;

7 See [https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment\\_data/file/8623/localpension.pdf](https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/8623/localpension.pdf).

8 See <http://researchbriefings.files.parliament.uk/documents/CBP-7309/CBP-7309.pdf>.

9 See [http://hummedia.manchester.ac.uk/institutes/cresc/sites/default/files/EnfieldExperiment\\_0.pdf](http://hummedia.manchester.ac.uk/institutes/cresc/sites/default/files/EnfieldExperiment_0.pdf) and <http://pirc.co.uk/pircnews/local-authority-funds-make-an-impact>.

- Investment brokers;
- Pension scheme managers and consultants;
- Lawyers and actuaries focused on pensions provision;
- Civil society leaders interested in pensions and local development.

The intention was to gain a greater appreciation of the opportunities around localising pension fund investments – and the obstacles that will need to be overcome. The main themes arising from the discussions are summarised below (the discussions were held in private, and therefore views are not attributed to particular individuals). Subsequently, the report considers what the main lessons and implications of these discussions are for the prospect of advancing localisation in pension fund investments.

## Previous SPERI research

Each seminar began with a presentation of previous SPERI research in this area, which has been published in the British Political Economy Briefs *Local Authority Pension Fund Investment Since the Financial Crisis* and *The Rationale for Local Authority Pension Fund Investment Decisions* (both co-authored by Craig Berry and Adam Barber).<sup>10</sup>

The key data compiled by this research compared asset allocations since the financial crisis between private sector defined benefit funds, local authority pension funds, and the largest local authority pension funds. See the tables below. Equivalent data for defined contribution investments is not available.

**Table 1: Private sector defined benefit funds asset allocation, 2006-2016 (%)**

	2006	2009	2013	2016
Equities	52.6	46.6	40.6	36.8
<i>of which: UK</i>	-	26.8	19.3	14.3
<i>of which: overseas</i>	-	19.4	20.4	21.6
Bonds	22.6	29.2	39.1	41.1
Cash	3.9	5.6	6.2	5.4
Property	2.1	2.8	3.6	3.7
Alternative (including infrastructure, private equity and hedge funds)	-	3.3	8.5	11.8
<i>of which: hedge funds</i>	-	0.7	5.0	7.9
Other	-	12.5	2.0	1.2

Source: PPF Purple Book (various editions), available at <http://www.pensionprotectionfund.org.uk/Pages/ThePurpleBook.aspx>  
 Note: figures refer to the average allocation level across all schemes included

<sup>10</sup> Both publications are available at <http://speri.dept.shef.ac.uk/speri-briefs/>.

**Table 2: Local authority pension fund asset allocation, 2005-2016 (%)**

	2005	2009	2013	2016
Equities	71	53	58	53
<i>of which: UK</i>	39	26	24	20
<i>of which: overseas</i>	32	27	33	33
Bonds	18	35	18	16
Cash	4	3	3	3
Property	7	6	7	9
Alternative (including infrastructure, private equity and hedge funds)	-	5	7.5	8.7

Source: Authors' calculations based on all funds' annual reports, available at <http://lgpsboard.org/>  
 Note: figures refer to the average allocation level across all schemes included

**Table 3: Local authority pension fund asset allocation, 2005-2016 (Largest 25 funds; %)**

	2005	2009	2013	2016
Equities	62	56	47	53
<i>of which: UK</i>	35	28	16	18
<i>of which: overseas</i>	27	29	31	35
Bonds	13	16	19	16
Cash	5	5	3	3
Property	10	7	9	9
Alternative	11	16	23	19
<i>of which: infrastructure</i>	1	1	4	4
<i>of which: private equity</i>	2	3	6	5
<i>of which: other (including hedge funds)</i>	7	12	13	9

Source: Authors' calculations based on annual reports of the 25 largest funds (as of March 2016), available at <http://lgpsboard.org/> Note: figures refer to the average allocation level across all schemes included

The most important recent development within private sector defined benefit fund investments is the move away from equities, which is steeper and steadier than the trend evident in local authority pension funds. This change is based mainly on a move away from equities *of UK firms*. The average allocations across private sector funds has declined by more than 12 percentage points since 2009, compared to a small rise in allocations to *overseas* equities. Local authority pension funds have also moved sharply away from UK equities, and more firmly towards overseas equities. This is especially the case, on both counts, for the largest funds – the average allocation to UK equities has halved to 18 per cent, while the allocation to overseas equities has increased from 27 to 35 per cent.

Generally speaking, the flipside of 'de-equitisation' is of course the move into more secure (but lower return) assets such as bonds, primarily gilts. The average allocation of private sector defined benefit funds to bonds rose from 23 to 41 per cent between 2006 and 2016. This trend, however, is not at all evident in local authority pension fund investments. Among all schemes, there was an immediate move into bonds in 2009 after the financial crisis, but this has now been reversed. Among the largest local authority funds, there is no evidence even of this initial shift, although the average allocation did increase from 13 to 16 per cent over this period.

Private sector and local authority funds are now allocating a larger portion of their funds to 'alternative' asset classes. In general, local authority funds are more willing to invest in alternative assets as they diversify, to some extent, having not moved firmly into bonds since the financial crisis. Interestingly, however, the allocation for the largest local authority funds fell between 2013 and 2016, from 23 to 19 per cent. Among the largest local authority funds, there has been a quadrupling of the average allocation to infrastructure between 2005 and 2016. However, this increase began from a very low base (1 per cent in 2005, now 4 per cent).

Among alternative assets, however, local authority pension funds remain far more likely to invest in private equity than infrastructure (although the two are not mutually exclusive). A consensus that the private equity industry, with attractively priced opportunities, will provide funds with above-average returns emerges very strongly from analysis of funds' annual statements. In the private sector, the move to alternative assets is largely explained by increased hedge fund investments.

Clearly, the available data on alternative investments is inadequate. It is not possible, for instance, to disaggregate specific allocations to infrastructure within the private sector, or local authority funds in general, due to inconsistent reporting. And we have very limited, if any, information on local investments within defined benefit funds in the public or private sector.

## Stakeholder discussion

**Constraints on pension funds.** The major constraint on localisation in pension fund investment strategies identified by participants was the need to deliver stable returns for members. Local authority pension funds may be managed in the public sector, but are essentially private money belonging to their members. Fund strategies, many argued, cannot be driven by social goods, or even meeting major, long-term economic challenges such as climate change.

As such, while virtually all participants welcomed the appetite for 'alternative' investments among pension funds, many also pointed out that alternative investment should not be equated with riskier investments. Funds often choose alternative investments in order to mitigate risk through diversification, and generally sought alternative assets that offered stability of returns (in contrast, increasingly, to equities). The experience of population ageing had hardened fund strategies in this regard.

**Short-termism.** At the same time, several participants pointed out that the conventional paths to delivering stable returns could be perilous – as demonstrated by the financial crisis, subsequent recession and reliance on quantitative easing by central banks. As such, the need to deliver stable returns should not be used to justify excluding alternative investment paradigms.

The inappropriateness of the reporting cycle for pension fund valuations was cited by some participants in this context. So too was the complexity, short-term incentives and expenses involved in investment intermediation within conventional asset classes. Generally speaking, this was a view articulated by academic and civil society participants rather than those more directly involved in pensions provision. One participant suggested the need for a broader definition of fiduciary duties in investment management, which could include a duty to contribute to the health of local economies, on the basis that this would also benefit local savers.

**Localisation risks.** While the benefit to members of a healthy local economy was generally recognised by most participants, many also argued that local investments exposed members to excessive risk. If there were a downturn in the local economy, members would suffer twice, by also see the value of their pension investments fall. One of the solutions to this, suggested by participants in each seminar, was for local authority pension funds to enter into reciprocal arrangements with funds from other areas to share the risks of investing locally.

The view that it was safer to invest in infrastructure overseas than in the UK's disadvantaged regions – due to the instability of government support for local infrastructure – was shared by many participants. A large number also expressed the view that pension funds did not, or should not, want to be involved in very early-stage investment, due to risks around commercialisation, construction, etc. Their preference is, or should be, for going concerns, where likely returns can be estimated more accurately.

More specifically, pension funds are, or should be, more focused on debt-financing, especially in relation to local projects. Pension funds are potentially a cheaper source of debt for many firms, and structuring deals in this way help to mitigate risks to funds. Some participants expressed the view that this preference among pension funds should be seen as an opportunity, with more debt-based products developed to support local economic development.

**Scale.** In general, it was recognised that pension fund investments require sufficient scale, given the size of many funds, even if smaller investments offer better returns. It is smaller or individual investors that have greater appetite for local investments, often because they are more aware of the local economic conditions.

One participant in Birmingham expressed the view that the pooling initiative could make local investments less attractive for local authority pension funds, insofar as it effectively increased the size of funds. Interestingly, no participants suggested that pooling within the local authority pension fund sector might be a vehicle for the kind of reciprocal local investments, among pool participants, suggested above.

**Mediation.** The scale issue speaks to a wider sense, expressed throughout the seminars, that the needs of pension funds and local economic development imperatives are not well-aligned. This is partly a structural problem, but also relates to a lack of information, expertise and intermediation at the local level. While there are concerns about over-intermediation in conventional asset management, there are far fewer mechanisms for introducing institutional investors to local investment opportunities.

Many participants engaged in local economic development expressed the view that potential investee enterprises have very little information about how pension funds invest – even local authority funds, which are integrated into local governance processes. Relatedly, there is a lack of pensions expertise among local officials.

Are pension funds approachable to be pitched opportunities? Most participants thought not. There was a sense in the Birmingham and Sheffield seminars that this applied less to Manchester, but most participants in Manchester were similarly downbeat about the approachability of pension funds in the area, including the local authority fund, to potential investees.

Many participants supported the idea of local authorities playing a stronger role in mediating between funds and potential investees. The creation of metro-mayors could enhance this role of local authorities as convenors; at the same time, some worried that messy structures of local governance, made messier by devolution in some areas, created confusion about who in local government would be responsible for such initiatives.

One participant in Birmingham expressed the view – to general agreement – that local authorities should not simply be mediating between investors and investees, but also leveraging public funds to attract pension funds at the appropriate stage (particularly in housing – see below). Some participants in Manchester endorsed the idea that local authorities needed stronger fiscal powers to enhance this leverage.

**Housing and planning.** Housing was identified by many participants as a major opportunity for the localisation of pension fund investments. (We should however be wary of selection bias; despite its myriad problems, the housing sector is very well-established as a local policy issue, and this was reflected in the seminar participants, to some extent.) There is clearly scope for local housing development to fit within funds' existing property portfolios, especially among local authority pension funds (and many have already moved in this direction).

Nevertheless, several limitations were identified. There was a sense that the rented sector was too poorly regulated for pension funds to be content to invest in sufficient volumes. There were also frequent references to planning risks – a much bigger barrier to local housing development than a lack of finance. One participant in Birmingham also cautioned that if local authorities were to create housing, in partnership with pension funds, that failed to realise its value, it could actually harm local economies.

In general, pension funds would always be wary of investing at the earliest stage of developments, even in housing.

**Member demand.** The seminars discussions, particularly in Manchester, also explored whether the ultimate owners of pension funds – the contributing members – wanted their savings to be invested more locally. The consensus was that they probably did, but what is much less clear is whether they would be prepared to accept lower returns or greater risks as a result. There was some support for pension schemes canvassing the opinions of members on this issue, but also the recognition that decisions around asset allocation are generally far too complex to expect individual members to make an informed choice.

**The private sector and defined contribution.** The seminar discussions generally focused, explicitly or implicitly, on local authority pension funds, with the recognition that such funds can and do invest in local economies other than their own. Many participants agreed that localisation was much more difficult within private sector defined benefit pensions provision, partly because schemes are closed to new members and/or accruals, and partly because the larger firms which tend to have maintained a defined benefit scheme were not tied to a single locality or region.

Participants obviously recognised the growing dominance of defined contribution in the private sector, but most admitted they little or no knowledge of defined contribution investment decisions and processes. But some participants, particularly in Manchester and Birmingham, expressed optimism that the large defined contribution trusts (such as NEST, established by government) offered increased scope for local investment. Moreover, there was a view – ironically, due to the lack of guaranteed pension outcomes in defined contribution saving – that member demand for local investment could drive this agenda.

## Implications and next steps

It remains regrettable that so much of the capital created by local economies (in the form of employees' pensions saving) ends up being invested anywhere but. The double exposure associated with local investment – whereby a local economic downturn might also be reflected in reduced returns on pension investments – is a significant consideration. Yet there are two main reasons for not over-stating this concern.

Firstly, the concentration of investment hitherto in London-centred capital markets has created similar risk dynamics, whereby a financial crisis led to a deep, national recession, as well as impacting conventional asset values very negatively. Furthermore, the growth of the City of London, partly assisted by pension fund investment practice, arguably contributed to the finance sector over-heating in the first place. The regulations, such as valuation cycles, that encourage pension funds to over-invest in so-called conventional assets should be reviewed, since the crisis proves that such assets are not as reliable as we might normally assume.

Secondly, even if it is unwise for a single pension fund to be exposed to a single, or small number of, local economies, it is nevertheless not unreasonable to expect an even distribution of pension fund capital by geography. In a balanced economy, localities and regions should perhaps expect to be in receipt of pension fund capital investment roughly in proportion to that which is created locally economy through pensions saving. This is a long way from being the case in the UK, thereby contributing to the geographical imbalances which lead to perceptions of excessive risk in localised investment strategies.

Of course, even if pension funds were more inclined, other things being equal, to investing in the UK's disadvantaged regions, we should not overlook the impact of demographic change (and its implication for fund valuations in the current regulatory climate) on the investment environment for defined benefit funds. A safety-first imperative underpins investment strategies, with the move to alternative assets such as infrastructure largely explained in this context, rather than as a stronger appetite for long-term investment with a higher risk profile.

One of the key assumptions in elite policy thinking is that greater scale will lead to a stronger appetite in this regard, enabling pension funds to play a role in rebalancing the UK economy. This explains the agenda around pooling among local authority pension funds. It is probably a fair assumption, but we should be sceptical of the notion that it might lead to more localised investment strategies. Arguably, greater scale means investment decisions are being made even further away from the local economies

where funds' capital is being created – policy-makers in central government, and pooled fund members, will have to monitor this issue carefully.

A clearer and more robust set of intermediation processes at the local level would probably have a more significant impact in this regard. Investors and potential investees need to be able to find each other. Local authorities can surely do more in this space – particularly following the creation of metro-mayors in many areas. But we must be mindful of a rather chaotic devolution process in many areas, which has arguably confused rather than clarified where responsibility lies for this area of policy. Policy-makers at the national and local levels need to consider whether local authorities, and particularly metro-mayors, have the necessary powers, and governance models, to enable this kind of function.

It may be that the publicly-owned British Business Bank (BBB) could also play an intermediary role in this regard too, especially in channelling pension fund capital into innovative SMEs. Importantly, the BBB is expected to increase its local footprint as it takes over the role that EU structural funds currently play in investing in disadvantaged regions. Exploring how the BBB could work alongside local authorities, metro-mayors and pension funds could be quite fruitful.

A clear implication of the seminar discussions is that, even if there were an array of investable projects in the UK's disadvantaged regions, the public sector is much better placed to make early-stage investments and shoulder attendant risks. A long-term, national investment strategy, backed by public funds, is probably a pre-requisite, but we should also be thinking about how local authorities can be empowered to invest more to unlock local financing opportunities. New fiscal powers could enable local authorities to offer stronger investment guarantees as part of their role as mediators.

We must not forget that private sector pensions provision is becoming increasingly dominated by defined contribution schemes. In theory, any of the measures explored here could be geared towards encouraging defined contribution-related funds, as well as defined benefit, to invest more in local economies. But while the funding pressures in defined benefit provision are circumstantial, in defined contribution they are inherent, and arguably therefore more acute. From the individual's perspective, pension outcomes depend entirely on investment performance. Hence the preponderance of insurance companies in defined contribution saving, and the related preference for conventional, ostensibly low-risk assets.

Greater scale is rightly seen as the main way of mitigating risks for the individual. Scale would also be a pre-requisite of any move to *collective* defined contribution (CDC), whereby individual members share risk with each other, but not with their employer. But this brings us back to the dilemma sketched above, that is, the trade-off between proximity to local economies and scale. Nevertheless, any move towards CDC, as long as it represents a 'levelling up' of individualised defined contribution, rather than a 'levelling down' of defined benefit, would be welcome, and surely improve the prospects for long-term investment via pensions saving.

Can schemes such as NEST be expected to divert some of their capital to local investments? What would investing 'locally' look like in a national scheme: a distinct mandate for a small part of the fund, or a localisation imperative across most or all of its mandates? Would it distribute investments in proportion to the location of its members – and would this require members to express a preference for investing locally? These are questions for NEST, but perhaps also central government policy-makers who oversee NEST's mandate and operations.

Schemes such as NEST are of course designed for small employers. A more effective path might be to encourage the private sector pension funds – whether defined benefit or defined contribution – associated with large employers to adopt a more localised investment strategy. This might apply especially to large 'anchor' employers embedded within a particular locality. But how this might be achieved is far from clear, even if the risks discussed here were mitigated. A voluntary approach would lack teeth, and a regulatory approach risks the prioritisation of securing member benefits in investment management.

It would be useful for large employers to survey their pension scheme members on the specific issue of local investments. Such conversations would inform, but not dictate, investment strategies. This is also presumably something that NEST could take forward, even without policy or regulatory change.

However, it may be that, if savers would like to see more of their capital invested locally, we need to consider alternative forms of long-term saving which enable this. Could individuals elect to assign a

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portion of their income to local investments rather than conventional pensions saving<sup>9</sup> Employers, or trade unions, could, in theory, facilitate this – and there may also be a role for local authorities. But the regulatory and tax implications, if such capital is to be invested beyond the scope of auto-enrolment legislation and pensions tax relief, would have to be carefully considered.

This project has of course only scratched the surface in terms of exploring the opportunities and barriers to localising pension fund investments. Further investigation will be required, ideally focused on:

- Developing a ‘census’ of the pensions capital created in the private sector across different localities and regions, and how it tends to be invested.
- The investment strategies of large defined contribution trusts.
- It will be vital also to explore the capacity of local authorities to engage with private sector pension funds.

It is worth mentioning, finally, that although this initial project did not engage in comparative research, the lack of major differences between the views of stakeholders assembled in different cities was noticeable. Interestingly, stakeholders in Sheffield and Birmingham see developments around pension fund investments in Manchester as exemplary – but most stakeholders actually based in Manchester acknowledge that the city has taken only tentative steps on a very long and potentially hazardous journey.

## Glossary

**Alternative investment.** Investments are often designated as 'alternative' if they fall outside the two most common asset classes (see the next entry). **Infrastructure** is often classed as an alternative asset, but infrastructure investment may also take the form of conventional equity or bond investments in infrastructure-related firms. Many pension funds favour **private equity** (investing directly in unlisted companies), or investing capital in **hedge funds** (pooled funds which are invested in highly liquid assets – which can be bought and sold quickly – in order to mitigate risks and achieve small gains in a very short period of time).

**Asset class.** Pension funds allocate their capital to various types of assets. The most common (or 'conventional') are **equities** and **bonds**. The former essentially means purchasing shares in listed companies, which lead to dividend income, or can be sold for a profit (or sometimes at a loss); the latter essentially involves lending money, either to government in the form of gilts, or the private sector in the form of corporate bonds.

**British Business Bank (BBB).** This body is a source of cheap finance for SMEs engaged in innovation. It is not a conventional bank, but instead uses government guarantees to source commercial finance for firms and projects which may otherwise struggle to attract investment.

**Debt-financing.** Many pension funds choose to offer credit to organisations involved in economic activity such as constructing or servicing infrastructure, rather than investing directly. This means that investment returns are stable, and agreed in advance.

**De-equitisation.** Many pension funds in the UK were once invested almost exclusively in equities. However, it is widely perceived that equity investment (especially UK equities) have become more volatile, especially since the financial crisis, and so many defined benefit funds have significantly reduced their exposure to equity markets.

**Defined benefit pensions.** Pension benefits for scheme members are determined in advance; members invest collectively through a pension fund in order to attain the funding targets which result, with their employer (the scheme 'sponsor') ultimately responsible for covering the cost of pension benefits, if investment returns are below target.

**Defined contribution pensions.** Scheme design is defined by the contribution, rather than the resulting benefit. Pension benefits are largely dependent on investment returns achieved by members investing on an individual basis (although pension providers will in practice pool the investments of individual members). The employer establishes the scheme, but has no funding responsibilities. In **collective defined contribution (CDC)**, members formally share investment risks, which in theory enable a riskier investment strategy.

**Diversification.** This is one of the key tools of **risk management**. It refers to the practice of partially divesting from conventional assets, especially when returns are low or volatile, so that investment risks can be spread across a wider range of asset types.

**Investment chain.** Various **intermediary functions** are present in the processes which turn an individual's savings into a returnable investment, depending on the type of asset to which capital is allocated. The Kay Review was critical of the short-term incentives embedded in the investment chain in the UK, especially in relation to equity markets, and many commentators have criticised the high costs of intermediation.

**Investment strategy.** Pension funds generally adopt a strategic approach to allocating their capital to different asset classes, and design **investment mandates** for investment managers (a key intermediary function) to reflect this strategy. The strategy is generally geared towards achieving funding targets specific to the scheme's financial and demographic circumstances.

**Local authority pension funds.** Large defined benefit funds for local government workers (and those in related employment), managed by local authorities. Benefits are common across all funds, as part of the Local Government Pension Scheme, and investment practice is governed, to some extent, by statute. Most funds cover the schemes of several local authorities, but in recent years, central government has encouraged further **pooling** (or merger) among funds.

**Metro-mayor.** As part of the devolution process, many local authorities have adopted a model whereby a single, directly-elected mayor oversees the work of several authorities within a city-region (or metropolitan area). Some mayors have new, devolved powers, some simply administer programmes delegated to combined authority secretariats by constituent local authorities, and some have very few formal powers or functions.

**National Employment Savings Trust (NEST).** A defined contribution pension fund created by the government, operating as the default provider of new schemes established following the introduction of **automatic enrolment** into workplace pensions. NEST is largely focused on providing pensions for small employers.

**The Pensions Regulator.** Regulatory body, overseen by the Department of Work and Pensions, which administers the application of statutory pensions regulation, most notably the valuation and probity of defined benefit pension funds in the private sector.

**Property investment.** Property is sometimes classed as an alternative investment, but usually treated as an asset class in its own right, especially within larger funds. Many funds invest in housing development, but investments in commercial property and land is more important to most investment strategies. Property investment is often undertaken via conventional assets such as equities (or private equity) and bonds.

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