Working with climate change campaigners
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Covid mortality rate ‘will not materially change LGPS costs’

Mr Houston said: “Yes, there has been an increase right across the board, whether it’s male/female, whether it’s age group, but those increases are not significant enough to change the cost to the scheme materially. They are 0.1%, is the conclusion.”

In a blog in July, the consultancy Barnett Waddington said that while the precise impact of deaths from Covid on the LGPS could not be predicted at that stage, many funds may already have seen a cashflow impact “with a larger number of death in service payments required in 2020 to date than would normally be expected”.

It added that funds may also have seen a liability impact, and that “if there have been a larger number of deaths, the liabilities for these members will have been reduced (if a spouse’s pension is now payable rather than the member’s pension) or removed”.

Mr Houston said that making sure pensions were paid and dealing with deaths through the pandemic had been a challenge for all LGPS administrators, but he told the seminar that “they have done an absolutely magnificent job”.

Another piece of work carried out by the advisory board had found that trends in deaths among LGPS pensioners had broadly followed the picture of the general population. In all regions LGPS mortality, expressed as a percentage of pension membership, peaked in April with London seeing the highest rate of about 0.45% and Scotland and Northern Ireland recording a similar figure.

New regulations ‘will force LGPS to report on climate change risks’

The government will introduce specific regulations for the Local Government Pension Scheme that will require council pension funds to assess the risk that climate change poses to their portfolios, the LGC Investment Seminar Scotland heard.

The Pension Schemes Bill being considered by MPs would allow the government to require pension schemes to assess and report on the risk of climate change.

Jeff Houston, secretary to the LGPS Advisory Board, told last month’s virtual event that regulations the Department for Work & Pensions intends to introduce for private sector schemes in the new year would not apply to the LGPS.

However, he said separate regulations with similar requirements would be introduced specifically for the LGPS.

“The understanding, certainly from conversations I have had with [the Ministry of Housing, Communities & Local Government], is that there will be regulations coming forward in England and Wales that won’t be a million miles away from the kind of regulations the DWP are going to be bringing out,” Mr Houston said.

“There will be requirements on administering authorities in the LGPS to assess the risk of climate change on their portfolios, to measure the impact of climate change risk on their portfolios, and to do a level of reporting out there.

“That’s going to have impact in terms of the kind of things we report out to our members,”

Mr Houston raised concerns about the proposed regulations limiting the discretion of LGPS funds to use divestment or engagement strategies to influence corporate actions.

“I have spoken to the DWP about making sure they are very careful that when you ask us to measure something you are not forcing us down one route or the other,” he said.
The role of secure income assets post-Covid-19

As companies seek a wider range of funding, they have more options to ensure stable cash flows

The global pandemic is expected to continue to influence the world around us long after its eradication. Potential changes to industry precipitated by the crisis include the ways in which we shop, travel, socialise and work. Secondary and tertiary effects may also become clearer over time. A trend we see accelerating is the disintermediation of banks, with companies seeking access to broader sources of funding as a result. In our view, secure income assets can play a crucial role here by helping support the regeneration of the UK economy and providing pensions funds with stable and long-term cash flows.

A brief history of private markets

Traditionally, banks have been one of the primary sources of funding for borrowers. In the early to mid-90s, a relatively small number of European borrowers began to take advantage of private institutional investment markets, using the availability of longer-term capital from the likes of US insurance companies to match their liabilities with income. This ‘private placement’ market, used by US borrowers for half a century, was now expanding internationally.

Over the next decade, these private markets grew significantly. However, a real step change in borrowing behaviour followed the financial crisis, when the willingness and ability of banks to lend, particularly to small and medium sized entities, declined. We observed a sizeable increase in issuance across sectors that had only sporadically accessed institutional money in the past – for example, housing associations and universities – and an increase in financings undertaken with more modestly sized companies that would not be able to access the public bond markets. We have also seen an increase in pension fund money stepping in to bolster available capital across sectors.

Current estimated direct GBP investment volumes across private markets are as follows:

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Approximate average GBP issuance (p)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real estate debt</td>
<td>£40bn</td>
</tr>
<tr>
<td>Infrastructure debt</td>
<td>£40bn</td>
</tr>
<tr>
<td>Corporate and alternative debt</td>
<td>£35bn</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>£115bn</strong></td>
</tr>
</tbody>
</table>

Source: LGIM internal data, August 2020

Private capital – a bigger role

In our view, Covid-19 may provide the catalyst for a further step change in private funding.

With parts of the economy having ground to a halt, the ability of companies to manage their liquidity has been stretched. This is different to the bank-led global financial crisis and is causing borrowers to review their sources of funding to ensure access to more diversified sources of liquidity. Going forward, using banks for short-term liquidity facilities and institutional investors for longer-term debt may strike a better balance for borrowers to manage the effects of economic cycles and bouts of market instability.

As a large institutional lender, we believe part of our role is to help navigate periods of uncertainty by providing core, more permanent debt. This implicitly helps companies steer through tougher periods while using more traditional sources of funding, such as banks, for shorter term liquidity. In our view, it also helps support the growth and development of sustainable businesses.

We believe pension funds also have an increasing role to play. These patient pools of capital marry well with companies seeking long-term funding, many of which are engaged in revitalising the UK economy by investing in new infrastructure projects, helping to refinance upcoming debt maturities or providing additional debt funding where needed. Pension capital could ultimately drive a return to growth through investing in these secure income type assets. Access to private markets for smaller pension funds, which may not want to make asset allocation decisions themselves, can be through pooled funds. Larger pension funds may prefer to invest through segregated accounts and co-investment opportunities in certain transactions.

1. Secure income assets (SIAs) identify cashflow outcomes from illiquid private asset classes, where the income stream often benefits from a range of contractual protections that enhance asset owners’ rights to maintain expected cashflows (for example, covenant protections, specific security or ringfenced collateral). The contractual protections of a particular asset will depend on these terms and the financial strength of the counterparty. SIAs are held with the aim of producing a predictable income stream – this income stream is not guaranteed and there is no underwriting of income.
Secure income assets ('SIA') identify cashflow outcomes from illiquid private asset classes, where the income stream often benefits from a range of contractual protections that enhance asset owners’ rights to maintain investment. Legal & general Amie Stow Stuart Opinion

SIAs are held with the aim of producing a predictable income stream – this income stream is not guaranteed and there is no underwriting of income. Expected cashflows (for example, covenant protections, specific security or ringfenced collateral). The contractual protections of a particular asset will depend on these terms and the financial strength of the counterparty. Local government chronicle

a result. In our view, secure income assets1 and providing pensions funds with stable can play a crucial role here by helping sup-

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nies to manage their liquidity has been
catalyst for a further step change in pri-

alternative debt £35bn real estate debt £40bn asset class

Current estimated direct GBP invest-

periods while using more traditional
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Case study: social housing

The UK continues to suffer from a shortage of affordable housing, with 1.3 million households on local authority waiting lists. An example of private capital’s role in the post-Covid growth of the UK economy is evidenced by a recent £100m long-term loan to Bromford Housing Group, the largest provider of affordable homes across central and south-west England. As a strategic partner of Homes England, Bromford has a key part to play in providing social and affordable housing; this partnership should be able to deliver 12,000 new affordable homes by 2028. These will serve the communities in which Bromford operates, as well as delivering both real economic growth and social value for the UK.

A wide range of borrowers are now looking to the private market for capital. We believe the majority of these require between £100m and £300m of debt finance, which is generally regarded as too small for public markets. We also see opportunities in more nascent sectors such as digital infrastructure and those in the crossover space, where access to other capital sources has become more challenged. The chart gives an overview of the diversity in sectors we have witnessed in the private markets so far this year, demonstrating the increasing breadth of secure income assets.

Conclusion
Over the past three decades we have witnessed a necessary and positive escalation of funding source diversification in the UK, enhancing the opportunity for borrowers and lenders. We believe this will continue to accelerate. For the private credit markets, this evolution can offer investors the opportunity not only to access a much greater range of investment opportunities, but also to help shape the world around us, particularly in the context of ESG-focused investment.

Providing financing for high quality assets across the UK such as social housing developments, renewable projects, logistic centres, offices in core locations and manufacturing businesses, among many others, is likely to align with many pension schemes’ objectives. It has the potential to increase certainty of returns and to generate cash flows to pay pensions, while also supporting the broader market recovery.

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The government’s proposals to end unlawful age discrimination in the Local Government Pension Scheme could themselves be at risk of legal challenge, the LGPS Advisory Board has warned.

In July, the Ministry of Housing, Communities & Local Government launched a consultation on its proposed remedy to the Court of Appeal’s judgement in the McCloud and Sargeant cases, which concerned the reform of public sector pension schemes from a final salary to an average earnings basis.

The changes to the LGPS included transitional protection for members who were within 10 years of their final salary scheme normal pension age on 1 April 2012, ensuring that they would receive a pension that was at least as high as they would have received had the scheme not been reformed.

The judges ruled that this statutory ‘underpin’ directly discriminated against younger members of the schemes, and in July 2020 the ministry said it planned to address the ruling by removing the age requirements from the underpin qualification criteria.

However, it plans to retain the 31 March 2012 cut-off date for receiving underpin protection. This creates a cohort of people who joined and paid into the LGPS when it was still a final salary scheme between that date and 31 March 2014, but who would not benefit from the underpin protection.

In its draft response to the government’s consultation, which closed last month, the LGPS Advisory Board warned that this aspect of the proposals could be open to legal challenge.

It says: “The proposed remedy does not extend the underpin to younger members who joined the scheme after 31 March 2012.

“These members will have final salary membership in the scheme but will not qualify for the new protection because the scheme changes were already publicised when they joined.”

The cost cap mechanism was introduced by the government to control unexpected changes in the cost of public service pensions.

In its July consultation document, the government estimated that its proposals would cost LGPS employers £2.3bn “in the coming decades”, and in a separate policy note the government said the costs of addressing the Court of Appeal judgement would be included in the cost cap process.

In its consultation document, the ministry said it “would not be appropriate” to provide underpin protection for people who joined the LGPS between 1 April 2012 and 31 March 2014.

It said: “Transitional protection, as applied across public service pension schemes, was always designed to help members with the transition from the old scheme designs to the new (in the LGPS, mainly in relation to the move from a final salary to a career average structure).

“Members who joined after 31 March 2012 will have joined the LGPS when either it had already transitioned to the career average structure, or when it was well publicised that the LGPS benefits were reforming.”

The ministry told LGC that responses to its consultation would be “carefully considered”.●
Until a year ago, the protests of climate change campaigners were a familiar sight to councillors arriving at Oxfordshire Pension Fund committee meetings. Each quarter, speakers demanded the immediate divestment from fossil fuel companies, and felt their pleas fell on deaf ears.

In June 2019, the committee took a significant decision which changed the position in Oxfordshire and started a new collaborative process: we set up a full-day workshop to discuss the issues and challenges, and invited representatives of all stakeholders. To ensure we got a proper balance of views, we approached Fossil Free Oxfordshire (FFO), a local campaign group, to submit nominations for presenters.

Just the act of approaching them changed the dynamics of the relationship, and instead of arguing across a committee table, both sides sat down and took the time to properly listen to the other’s point of view. While there were significant differences of opinion, we were all surprised about much we had in common.

To ensure the workshop was impartial, we appointed an independent facilitator. With FFO’s input, we invited a list of participants covering academic research, investment houses, university students, scheme members and the Church of England, as well as Faith Ward, chief responsible investment officer at the Brunel Pension Partnership, the Local Government Pension Scheme pool we are a member of, and a representative from the Environment Agency Pension Fund, one of our partner funds within Brunel. The day was focused on identifying common ground, key issues and next steps.

Following the workshop a small working group, again including FFO and a scheme member representative, turned the key points agreed at the workshop into the first draft of our new climate change policy. FFO had moved from being a campaign group on the outside to working alongside officers in developing our formal policy documents, and while disagreements remained, these were now acknowledged, compromise sought, and a focus maintained on achieving the key outcomes we all shared.

The key elements of our policy are an overarching commitment to ensuring the fund’s investments are aligned with the Paris Agreement: net zero carbon emissions by 2050 and a 1.5°C limit on the rise in global temperatures. We have also agreed an annual target of 7.6% reductions in the fund’s greenhouse gas emissions in line with the UN Environmental Programme’s findings on requirements consistent with a 1.5°C model.

Working with FFO has also helped in our communication strategy. We have been able to talk to them about why our messages were not landing, and test messages on them. They have provided critical challenge about the proof we have that our strategy of engagement is working.

FFO would still like an immediate divestment from fossil fuel companies on the basis that their current business models are not consistent with our new key target of limiting global heating to 1.5°C. However, the committee has supported the position of Brunel not to impose a blanket divestment policy, but to focus on continued engagement and selective divestment. FFO will continue to work closely with the committee on this point as a critical friend and will remain on the working group looking at the implementation plan for delivering our policy.

Key challenges still faced include agreeing a basket of metrics against which we can set interim targets to monitor our performance. Linked to this, FFO has been keen to set out the sanctions to be applied when performance falls short of target, whether that is removing a fund manager, divesting from a company or proposing further changes to our asset allocation to portfolios more closely aligned with the Paris Agreement. The committee has agreed to review the policy on an annual basis with regular update reports to its quarterly meetings.

Bringing FFO to the table as a critical friend has brought a much greater understanding of the issues among all parties, and has improved the drive for transparency and the identification of metrics and targets to measure our progress and sanctions for non-compliance.

We still have our disagreements, but these are now discussed openly, and alternative views respectfully accepted where we agree to differ. We still have a long way to go but travelling together feels so much better than it did before.

While there were significant differences of opinion, we were all surprised about much we had in common.

Sean Collins
Service manager, pensions, Oxfordshire CC

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**Environnent**

Bringing climate change campaigners in from the outside

A decision to work constructively with campaigners resulted in more expertise, constructive challenge and better communication.
Attractive characteristics,
A favourable backdrop for real estate alternatives to fixed income

**Demand for yield remains high**
Local Government Pension Scheme investors continue to grapple with increasing member maturity, making the search for greater investment income ever more pressing.

The continuing low yield environment has fuelled demand for alternative investment opportunities that offer a return premium without sacrificing the required risk characteristics. However, many investors are not aware that there are real estate solutions which can meet both of these needs.

Real estate long income and real estate credit can provide the yield premium that LGPS investors require, while retaining many of the attractive features of fixed income, including long-term, predictable, inflation-linked income. But successful investment and portfolio management relies on specialist understanding of real estate markets and expert understanding of property-specific fundamentals.

**Long-term, inflation-linked income**
For investors searching for attractive risk-adjusted returns driven by inflation hedged, stable cash flows over the long term, real estate long income is an attractive solution. Broadly speaking, real estate long income refers to properties that are leased to tenants for between 15 and 150 years. Depending upon the structure chosen, the investor or tenant retains the property at the end of the lease. Depending upon the specific investment, risk mitigation is gained from recourse to tenants with superior credit strength, and/or ownership of property underwritten on the basis of a lower rent than that achievable on the open market, or having been bought for an amount lower than the potential sale proceeds achievable on the open market. With returns driven by long-term cash flows and index-linked rental uplifts, the strategy also offers the ability to match investors’ liabilities. Compared with fixed income, real estate long income has historically delivered attractive risk-adjusted returns, lower volatility and a consistent illiquidity premium.

Real estate credit also offers attractive income benefits, favourable risk-adjusted returns and portfolio diversification. In simple terms, real estate credit refers to private loans, or mortgages, secured against commercial real estate and used for either acquisition financing, or refinancing of existing loans. It has historically generated higher yields than investment-grade corporate debt, while diversifying away from directly held real estate or traditional liquid investments like corporate credit. Real estate credit can also be structured to offer an

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**Property yield spread versus fixed income**

- **Spread**
- **UK BBB corporate bond, 10 years**
- **All property initial yield**

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Andrew Davey
Senior director, UK long income
Emma Huepfl
Managing director, EMEA credit strategies, CBRE Global Investors

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CBRE Global Investors

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lGCplus.com
explicit link to inflation through floating rate loans hedged by way of an interest rate cap.

Protected by underlying asset quality
Real estate long income also offers a viable alternative to fixed income in terms of credit quality. The credit strength of a long income investment is determined by the level of collateral provided by each property or the financial strength of the tenant counterparty. As the type and level of credit quality can vary, the attractiveness of the property is extremely important. If a tenant defaults, the recourse for investors is to retain the underlying interest in the property, making the property's value an enduring source of security. Real estate credit offers the benefits of contractual income streams generated via lease payments from property tenants, with additional downside protection provided by the asset's collateral. As loans are typically secured against the asset and the borrower is not personally liable, lenders need to ensure there is a good understanding of the underlying property in the event of a default.

A thorough grasp of property fundamentals and how they behave across the cycle is essential to correctly assessing the risk of both these investments.

Identifying opportunities and value
CBRE Global Investors' breadth and depth of expertise in real estate allows us to find and access compelling opportunities in real estate long income and real estate credit as they arise. We have an extensive view of the market, a heightened understanding of the risks currently at play, the information needed to identify pockets of good value, and, crucially, access to deal flow in a tight market.

With the pandemic expected to last into 2021, we are carefully monitoring some key opportunities. Demand for liquidity and credit is rising as risk appetite from traditional lenders has lowered. This leaves an opening for non-bank lenders to step in and provide flexibility and well-structured financing to borrowers at attractive prices.

We are also watching closely as pressure increases on investment-grade corporates. With volatility amplified by the pandemic, downgrades to sub-investment grade could rise. It is shortsighted to view a long-term lease with an investment-grade corporate tenant as adequate protection. In our view, the quality and attractiveness of the underlying asset is always paramount.

The compelling case for LGPS funds
Against a background of uncertainty, both real estate long income and real estate credit offer attractive characteristics as investors look to diversify investment risk towards income-oriented asset classes. With both of these investment opportunities, LGPS funds can benefit from:

- Higher yield than fixed income
- Long-term, stable cash flow
- Inflation-linked income that enables liability matching
- Attractive risk profile, supported by high-quality real estate fundamentals.

THE MARKET
UK loan origination by lender type (£bn)