Division(s): N/A

PENSION FUND COMMITTEE – 6 JUNE 2014

GOVERNMENT CONSULTATION – LGPS: OPPORTUNITIES FOR COLLABORATION, COST SAVINGS AND EFFICIENCIES

Report by the Chief Financial Officer

Introduction

1. On 1 May 2014, the Department for Communities and Local Government (DCLG) published their consultation document on the options for the future structure of the Local Government Pension Scheme (LGPS). The document, under the title Local Government Pension Scheme: Opportunities for Collaboration, Cost Savings and Efficiencies, invites responses by 11 July 2014. This report details the key elements of the consultation, the potential impact in exploring the closer working with the Buckinghamshire and Berkshire Funds, and invites the Committee to agree the basis for a response.

Consultation Document

2. The consultation document builds on last year's Call for Evidence and the work commissioned from Hymans Robertson to undertake a specific review of options on the future structure of the LGPS. The Government have also drawn on the analysis of the call for evidence responses provided by the Shadow Scheme Advisory Board.

3. The Board's analysis suggested a strong consensus on a need for some reform, but a divergence of views on the shape that reform should take. There was strong argument against a "big bang" approach or forced mergers. There was though acceptance of the benefits of:

   - Greater collaboration
   - Increased use of Passive Mandates
   - Use of Collective Investment Vehicles
   - Development of structures to allow increased use of in-house investment

4. The majority of responses argued that there was a clear lack of consistent data against which to make decisions, and supported a call for the collection of a national consistent data set. In commenting on current data, the consensus was that whilst there was evidence of indirect benefits of larger fund sizes, there was no conclusive evidence of a direct link between fund size and investment returns in the LGPS.

5. The Board report highlighted that a large number of respondents referred to the importance of retaining local political accountability, and the direct link between investment decisions and council tax payers. However the report went on to state that there was little, if any, empirical evidence to support this position. As previously noted, these views are strongest in London where each Borough Council is responsible for its own fund, whereas outside London, there is no such one to one relationship between Council and Fund.

6. There was also an argument that a greater degree of separation between scheme manager and lead authority may lead to an improvement in governance, through a reduction in the potential conflicts of interest.

7. The latest consultation document builds on these views, as well as the findings from the Hymans work. In particular, the Government believes there are savings of £660m per year to be made through reform of the current arrangements. The potential savings are based on a combination of the use of collective investment vehicles and a switch from active to passive mandates for all listed investments. The consultation document has indicated that formal mergers should not be taken forward at this time.

8. Based on the Hyman's work, the consultation document argues that in aggregate across the LGPS, active managers have failed to deliver value for money, with performance levels broadly in line with those of the market, for fees considerably higher than those of passive managers. Using the Hyman's work, the document projects savings in manager fees of £230m per year if all Funds switch their listed investments to a passive manager, invested through a single collective investment vehicle.

9. The second potential benefit of a single collective investment vehicle for listed investments is a £190m per year saving on transaction costs, based on reduced stock selection decisions, as well as the ability to match the purchase and redemption of new units in the Fund between schemes without the need for market transactions.

10. The Hyman's work indicated that the greatest scope for investment fee savings was in the area of alternative assets. Fees in this area accounted for 40% of total fees, although the asset class only made up 10% of the overall allocation. The consultation projects an annual saving of £240m from moving all alternative asset investments into a second collective investment vehicle, and out of the current Fund of Fund arrangements.

11. After allowing for the costs of transition, the consultation document suggests that the fee savings accruing from the switch to passive management could be deliverable within 2 years. The savings on the switch to the collective investment vehicle for alternative assets is projected to take up to 10 years to fully materialise, allowing for existing contractual arrangements to conclude without the need for excessive termination costs.

12. The decision not to pursue formal mergers at this time is based in part on a longer projected timescale to deliver the savings compared to the collective

investment vehicle model. Hyman's suggest an 18 month longer implementation period. There is also an acknowledgement of the importance given to local accountability in the responses to the Call for Evidence, and the wish to take decisions on asset allocations linked to local funding level and cash flow issues.

13. The Government do though acknowledge the need to improve the transparency and comparability of performance information around the LGPS as a means to ensuring local Pension Fund Committees can be better held to account. The have asked the Shadow Scheme Advisory Board to continue to develop their work in this area, including the publication of a scheme-wide annual report.

14. The Government considered the merits of consulting on options in respect of administration costs, but the document notes that the level of potential savings is significantly lower, and at this time of major change in the scheme regulations, it is important to allow the administrative arrangements for the 2014 Scheme to mature before considering reform any further.

15. The consultation document asks 5 specific questions:

- Q1. Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Please explain and evidence your view.
- Q2. Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?
- Q3. How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?
- Q4. What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?
- Q5. In light of the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance, which of the options set out above offers best value for taxpayers, Scheme members and employers?

16. In respect of the fifth question, the options outlined in the consultation document are as follows:

- Funds could be required to move all listed assets into passive management, in order to maximise the savings achieved by the scheme.
- Alternatively, funds could be required to invest a specified percentage of their listed assets passively; or to progressively increase their passive investments.
- Fund authorities could be required to manage listed assets passively on a "comply or explain" basis.

- Funds could simply be expected to consider the benefits of passively managed listed assets, in light of the evidence set out in this paper and the Hymans Robertson report.

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Initial Issues for Consideration

17. Whilst there was broad support for the need for reform, there is some question as to whether this consultation document is too narrowly focused on costs as opposed to the wider objective of ensuring a scheme that is affordable and sustainable in the long term, and able to meet the liabilities of current and future scheme members.

18. There is also a concern that the projected savings on fees are over-simplified, as is the argument for a whole scale switch from active to passive management for all listed assets, with a number of potential unintended consequences overlooked.

19. A significant criticism of the consultation document is that there is limited focus on the issue of scheme governance. The Government approach also appears to be inconsistent in its acceptance of the argument on the importance of local accountability on asset allocation, alongside its argument that local Committees should have reduced flexibility of decisions between active and passive management.

20. A second significant criticism of the document is the apparent acceptance of a standardisation around average performance rather than a drive to improve performance as a key element to address current funding deficits. There is very limited analysis of the variations in performance between funds, and a simply assumption that the active management industry fails to deliver value for money, as aggregate performance is no better than that achieved by passive management for considerably higher fees.

21. By definition, active managers cannot outperform the market in aggregate. Key questions therefore include:

    - To what extent do active managers drive market performance as a whole, a performance which is then simply reflected in the performance of passive managers. i.e. if there were no active managers, would the market have achieved the same investment returns?
    - Are there clear lessons to be learnt from those Funds where active managers have outperformed the index? It is accepted practice that Funds tend to fire managers at the trough of their performance and hire managers at the peak of their performance. Good governance models will therefore ensure that managers are judged over the longer term and turnover of managers limited to issues of strategic change, or where a manager changes style/approach and is no longer delivering against the objectives set for them. What therefore is the pattern of manager turnover amongst high performing funds and low performing funds, and do poor aggregate results reflect more on poor scheme governance than the active management industry?

- What levels of target outperformance have been set for Fund managers? Many funds target out-performance of 1%-1.5%, encouraging managers to closet track indices and deliver performance close to the market. Aggregate levels of out-performance need to be assessed in line with the risk levels taken by individual funds, and the level of risks expected of their active managers.

22. Rather than simply accepting average performance, the consultation should be seeking views on how to improve governance within the Scheme as a whole, to ensure that the benefits of active management are achieved across all funds to the benefit of all stakeholders.

23. This issue could suggest that the Government are wrong to park for now the issue of scheme mergers and retaining the current 89 local administering authorities. Looking to reduce the numbers of administering authorities either through full mergers, or the creation of Joint Committees could have the benefit of allowing for greater specialism amongst Committee members, improving the oversight of active fund managers, and driving sustainable out-performance. The potential improved investment performance if all Funds deliver at the level of the best performing funds could dwarf the £600m fee savings of standardising at average performance levels.

24. The issue of the skills and knowledge of Committee members is an issue the Pension Regulator will be looking at as part of his new responsibilities for the LGPS from next year, and further attention maybe focussed on this issue if IORP 2 requires all Committee members to be professionally qualified.

25. Other benefits which would stem from a reduction in the current 89 decision making bodies would be greater consistency of decision making in respect of scheme employers who belong to more than one fund at present, including a number of Housing Associations and Academy Trusts

26. In terms of the financial savings, the targets are based on the assumption of 100% take up of passive investment of listed assets through a common investment vehicle, and all alternative assets managed through an investment vehicle. If the Government determine not to mandate the solution on all Funds, a 100% take up is unlikely.

27. Firstly, where local schemes remain accountable for their own asset allocation there are likely to be significant variations in choices. Running a restrictive set of choices through the collective investment vehicles is therefore likely to discourage funds from investing. On the other hand, an overly flexible offering will remove many of the advantages of the economies of scale so reducing the delivered savings. A key question here is the definition of passive investment, with today's market offering a significant number of smart beta options, with numerous alternatives to market capitalisation weightings including equal weightings, ethical only investments, growth focused benchmarks, income focused benchmarks etc.

28. It is also likely that those Funds who have seen their active managers out-perform will opt not to join the collective investment vehicle. Similarly, the fees the largest funds have currently been able to negotiate with their managers, means that they too will have little incentive to join the collective investment vehicle.

29. Another factor which requires further analysis is the level of the potential savings quoted for the introduction of a single collective investment vehicle for alternative assets, as opposed to the current fund of fund models. Where the Government is still looking to determine the nature of the collective investment vehicle, there is a clear risk that it simply becomes a fund of funds by another name, retaining the double fee level structure, and delivering little of the potential savings. The alternative of running an in house structure to directly manage the complexity of the alternative asset markets is likely to lead to significant in-house costs.

30. The final point on reducing fund manager fees is the extent that fund managers can look outside of the LGPS for business at existing fee levels. Most managers take business across the global market, and not all will happily agree a fee reduction to retain LGPS business, where they can sell the service elsewhere.

31. Of the non-financial factors, one of the key issues of the switch from active to passive mandates is in respect of environmental and social governance (ESG) issues. Principle 1 of the United Nations Principles of Responsible Investment states "we will incorporate ESG issues into investment analysis and decision making processes". How this is evidenced becomes less clear when investment decisions are all made passively and religiously follow an index. Whilst we encourage all our fund managers to engage with companies to resolve all ESG concerns, active managers also hold the ultimate weapon to dis-invest where sufficient improvements are not forthcoming. Such an option is not open to the passive manager.

32. On the fixed income side, the passive manager may also be forced by following an index to increase an investment in a company the more indebted it becomes, and its debt becomes a larger share of the index. Whilst passive management plays an important part of an overall asset allocation, it is not clear that sole reliance on a passive approach solves more issues than it creates.

Implications for the joint work with the Buckinghamshire and Berkshire Funds

33. So where does this consultation leave the joint work with the Buckinghamshire and Berkshire Funds? Whilst the headlines of no mergers and the focus on collective investment vehicles would appear to run counter to the approach taken by the Government, closer analysis may suggest otherwise. Indeed, the current preferred model for the establishment of a Joint Committee to taken on delegated responsibility from the three current Pension Fund Committees and

the development of a joint investment strategy potentially addresses many of the benefits of the Government's approach, plus the issues identified above.

34. The establishment of a single investment strategy for the three funds is in itself a form of collective investment vehicle, but unlike the Government model, also has the benefit of a collective governance model. This automatically addresses the risk of too much flexibility in the asset allocations of the administering authorities to deliver the scale required to make a collective investment vehicle cost effective.

35. The increased scale of the support arrangements for the joint committee also increases the potential in the future for developing in-house management for part of the investment portfolio, which in turn should reduce the overall level of investment fees. There is nothing in the current project planning to limit the work of the support body to a single joint committee, (or indeed to limit the numbers of funds who could delegate their current responsibilities to the Joint Committee). The model for Buckinghamshire, Oxfordshire and Berkshire therefore has the potential to be of a scale to deliver savings in excess of those envisaged by the Government proposals, whilst addressing a number of the concerns with the Government model.

Consultation Response

36. The publication of the Government Consultation Document and the 106 page report from Hymans on 1 May 2014, has been followed up by the NAPF Conference which was addressed by Brandon Lewis MP on 20 May 2014. A number of stakeholders in the industry are currently working on consultation responses, and in particular, looking to collate the evidence to support their views as called for in the specific consultation questions.

37. Given the level and timing of this activity, it has not been possible to complete an initial draft response to the consultation document to be included with the publication of these papers. However it is intended to complete the first draft along the lines of the issues identified above, and have this circulated in advance of the Committee. It is then proposed to prepare the final response taking into account the views expressed by the Committee and the subsequent evidence produced by the various stakeholders, ready for submission by the 11 July 2014 deadline.

RECOMMENDATION

38. The Committee is RECOMMENDED to

(a) note the report;

(b) offer any views it wishes to see incorporated into the final response;

(c) ask Officers to continue with the joint work with the Buckinghamshire and Berkshire Funds to the extent that it is

consistent with the approach included in the consultation response; and

(d) delegate to the Service Manager (Pensions, Insurance and Money Management) the authority to finalise and submit the response to the consultation, having consulted the Chairman, Deputy Chairman and Opposition Spokesperson on the final draft. .

Lorna Baxter
Chief Finance Officer

Background papers: Department for Communities and Local Government Consultation document - Local Government Pension Scheme: Opportunities for Collaboration, Cost Savings and Efficiencies.

Contact Officer: Sean Collins , Service Manager (Pensions, Insurance & Money Management), Tel: (01865) 797190

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