Proposals for Greater Collaboration between the Buckinghamshire, Oxfordshire and Berkshire Local Government Pension Funds

Report of the Chief Finance Officers

Introduction

The initial consideration for this work began some 3 years ago, as part of a conversation between the Chief Finance Officers for Buckinghamshire, Oxfordshire and Windsor & Maidenhead (who administer the Berkshire Pension Fund). The aim was to examine the scope for efficiencies through the sharing of best practice, and greater collaboration on the management of investments.

The work was given greater impetus by the statements of Brandon Lewis MP during his time as the lead Minister for the Local Government Pension Scheme (LGPS), in which he questioned the sense of retaining the current 89 separate Administering Authorities in England and Wales. There was a view that it would be better to explore the options including full merger of the Funds under our own programme, than wait for a solution to be imposed on us directly by Government.

The Government has subsequently moved away from the idea of full merger, given the requirements to establish primary legislation, and the need to ensure the new merged bodies would have tax raising powers to meet pension liabilities in the extreme event of no more active members of the Fund. However, the pressures to reduce current funding deficits, and the financial constraints on public services as a whole, mean that the benefits of greater collaboration are still worth exploring.

Rationale for Proposals

Given a key objective is to reduce funding deficits and reduce the pressure on the scheme stakeholders, a key consideration has to be in respect of the financial benefits of greater collaboration. Financial benefits need to be considered in terms of both potential improvements to investment performance, and reductions in the levels of costs. There is greater consensus in terms of the latter. Two key areas of potential reductions in costs without significant impact on investment performance are as follows:

- Lower Investment Fees.

  There are a number of pieces of evidence to suggest that investment fees are directly related to fund size, not least the fact that many Fund Managers charge ad valorem fees where the rate of charge reduces as the mandate size rises. Fund Managers justify such a structure as it allows them to recover their costs which are fixed irrespective of fund size, whilst passing on the benefits of scale.

  Hymans Robertson, one of the main consultancy firms providing support to the LGPS, and responsible for the recent collaboration report on behalf of the Government (see below for more details) have provided information on

effective fee levels for different sizes of active equity mandates. These are shown in the table below.

Mandate Size	Effective Fee
£50m	0.600%
£100m	0.525%
£200m	0.462%
£400m	0.406%
£1bn	0.372%

Many of the current mandates within the three funds are in the £100m - £200m range, and these could increase to £500m plus if combined, suggesting potential fee savings in the region of 6 – 12 basis points on active equity mandates. N.B. In looking to maximise the potential fee savings by bringing together all like mandates under a single manager, a balance will need to be struck to avoid excessive single manager risk.

State Street Investment Analytics, responsible for providing performance management support to the vast majority of LGPS Funds, have also published research on the impact of size on fee levels. This indicates an average fee level for Funds in the £1bn to £2bn range (the current size of the three individual funds) as 0.29%, compared to 0.23% for a £5bn Fund, as the combined Fund would be. This would suggest potential fee savings in the region of 6 basis points across the funds as a whole.

The initial work undertaken by the London Councils in developing their proposals for a London Wide Common Investment Vehicle have also identified potential fee savings from introducing common mandates. The business case presented to the Leaders Committee in February 2014 identified these savings at 15 basis points.

The scope for savings will differ between the various asset classes currently held. Minimal savings will be achievable on combining existing passive mandates given the current lower fee levels on these mandates. Savings on private equity and property mandates could be potential significant if through the increased size it became economic to manage then internally in the future – such savings though would take much longer to realise due to the illiquid nature of the asset classes.

The actual financial benefits on collaboration will be dependent on the current fee levels, and actual asset allocation of the funds when combined. On the basis of the above information, it is reasonable to target financial benefits of 6 basis points, which across the three funds would amount to £3m per annum.

- Lower Staffing/Support Costs

  A move to a common investment approach and a single administration service should both allow for savings in the staffing and support budgets for the three administering authorities. The greater the degree of collaboration the greater the potential saving, with the ability to reduce senior management

and advisory costs, as well as running a single communications team and payroll system.

It is important to note that the majority of the administration work is in support of individual scheme employers and members, and this will not reduce through collaboration, though over time there may be some savings as the work is standardised around best practice and more consistent use of technology and systems.

As noted above, reducing costs should not be seen in isolation from improving investment performance. There is far greater potential for delivering improved investment performance than there is for reducing costs. Whilst duplication of effort can be removed to deliver savings, care needs to be taken to ensure the new investment team is sufficiently robust to provide proper oversight of the funds' investments.

The initial work on exploring potential savings in staffing and support costs has identified a potential savings figure of £465,000 per annum. This figure comprised:

Senior Management costs	£110,000
Committee Advisors/Investment Consultants	£215,000
Committee Services	£ 40,000
External/Internal Audit	£ 50,000
Performance Management Services	£ 20,000
Altair (Pensions Administration) System	£ 30,000

There are other potential benefits of greater collaboration. These include:

- Increased Resilience – Given the current size of the three individual Pension Funds and the pressure on minimising costs throughout the Public Sector, all three funds operate with small investment and administration teams. This leaves them exposed to the loss of key individuals. Greater collaboration will reduce this risk by allowing for the sharing of resources across all three funds, so that each fund can benefit from the skills and knowledge held across all teams, rather than being totally reliant on their own teams.

- Opportunities for an element of Employer choice in investment strategies. At present, all three funds operate a single investment strategy for all employers within their fund. There is no allowance for the different funding levels of individual employers within the Fund, differences in employer risk appetites or differences in the financial strength of the employers. Whilst the individual funds could introduce multiple investment strategies to meet the requirements of their employers, the greater scale associated with increased collaboration will improve the viability of each strategy by increasing the numbers of employers covered, as well as improving the ability to absorb any additional administration costs. Such a model thereby introduces a greater degree of choice for the individual scheme employers, who with the approval of the Joint Committee (see Proposed Operating Model below for detail) will be able to determine an investment strategy more aligned to their own circumstances.

- Opportunities for Risk Reduction through Greater Diversification. The greater size of the investment Fund will also open up additional diversification opportunities, where a minimum size of investment is required to enter the market e.g. direct investments in property. Greater diversification where managed well should reduce the overall level of risk and volatility within the Fund. Care does need to be taken though or there is a risk that smaller, more "boutique" investment houses will be excluded from consideration, as they will not be able to deal with larger mandate sizes.

- Potential Future Investment Savings through introducing an element of internal management, and increasing the size of the governance budget. Research undertaken by State Street has identified that those LGPS Funds which do operate with some level of internal management do make savings on the overall level of investment costs without any detriment to performance. Research by others, including Clerus, have identified improvements in investment performance linked to improved levels of governance. Both of these issues would need to be further explored by the Joint Committee beyond the initial collaboration programme.

Impact of Government Consultation

We are currently awaiting the Government's response to their recent consultation exercise on greater collaboration, which in turn followed the work undertaken by Hymans Robertson noted above. This report focussed on Common Investment Vehicles and a switch to passive mandates as the key drivers for reducing costs. A key question therefore is what impact would a decision by the Government to impose a solution on all LGPS funds have on the rationale for any proposed collaboration.

The impact of a decision to require all LGPS funds to allocate a given percentage of their funds to passive mandates is easier to determine, than the impact of a decision to establish Common Investment Vehicles. Passive mandates attract significantly lower levels of investment management fees, and as such it is unlikely there would be further potential fee savings through collaboration. As there are a number of passive fund managers already working with LGPS Funds, any change would be relatively quick to implement (although speed would need to be assessed against the costs of transition and the benefits of delaying sales to maximise prices). However it would be reasonable to state that any Government proposal to determine a high weighting for the required allocation to passive mandates would therefore eliminate the main financial savings associated with collaboration. A government decision to impose passive mandates should therefore be considered a significant risk to the proposed greater collaboration.

If the Government was successful in establishing Common Investment Vehicles which covered the mandates of the current three funds, then it is likely that the fee savings through investing in the CIV would at least equal those that would be obtained through greater collaboration limited to just the three funds. However, unlike a decision on passive mandates, it is not clear how the Government would impose a Common Investment Vehicle solution on the LGPS. Whilst the impact on any business case would be significant, the likelihood of such an event in the short

term is such that this would appear to be a lesser risk to the proposed greater collaboration. Indeed, the collaboration project could form the basis of any future development of the CIV model by Government, making this an opportunity rather than a risk.

What Financial Benefits could be delivered whilst retaining the current three Committees?

The initial report on greater collaboration identified a range of options which ranged from full merger of the Funds to the retention of the existing structures but with increased project work across the three funds. The report identified that the benefits would increase in line with the extent of the collaboration. However, before making the decision to move to a Joint Committee model, it is appropriate to review the potential financial benefits of retaining the current three Committees.

The first issue would be to determine the extent of the responsibilities of the three Committees. If these were to remain unchanged, then there is very limited scope for delivering investment fee savings based on economies of scale. As discussed in greater detail below, the three funds currently have very few common mandates, where the asset class, performance target and fund manager are the same.

To deliver investment fee savings associated with improving economies of scale therefore the three Committees would need to relinquish responsibility for fund manager selection, whilst retaining responsibility for the overall asset allocation decisions. The figures analysed below suggests that all three funds allocate resources to global equities, fixed income, private equity and property, representing around 50% of the total funds. Common mandates between two funds would be possible for a further 25% of the assets, covering UK equities, diversified growth funds, and hedge funds, whilst the remaining 25% of assets relate to asset classes held by just a single fund. Whilst therefore there is potential for significant savings through economies of scale, the management of this would be complex. Advice from Fund Managers suggests that fee savings will be minimised, if there is a requirement to retain separate reporting lines to the individual Committees.

The actual level of potential benefits would vary depending on the nature of future asset allocation decisions made by the individual committees. The greater the divergence of decisions, the lower the potential benefits. As asset allocations move closer to a common position, the total potential benefits would move closer to the 6bps identified above. Such a position though would simply strengthen the case for a Joint Committee to deliver the full range of potential benefits.

The individual Committees could also seek to achieve savings independently of each other. A development of national procurement frameworks for investment mandates, the opening up of the proposed London CIV or the development of alternative CIVs will all create the opportunity for delivering investment fee savings. At the present time, none of these options are available, and it is difficult to predict the timescale associated with the development of such opportunities.

Overview of Current Funds

Appendix 1 to this report brings together key information on the current three Funds. To minimise the risks of inconsistencies between the data, the data has all been taken from the Actuarial Reports prepared for the three Funds, as all three Funds have employed Barnett Waddingham.

Key points from the data are as follows:

- The funding level of the three funds was broadly similar at the 2010 Valuation, though by 2013 Berkshire's funding level had fallen to 75%, whereas that for Buckinghamshire and Oxfordshire had risen to 82%.
- The average employer rate for the three funds was broadly similar, being 19.3% for Berkshire and Oxfordshire and 19.5% for Buckinghamshire. The average recovery period for Buckinghamshire though was significantly shorter at 17 years compared to 25 years at Oxfordshire and 27 years at Berkshire.
- Total Fund Liabilities are broadly comparable ranging from £1.839m at Oxfordshire to £2.157m at Buckinghamshire. Fund membership ranged from 53,366 members within the Oxfordshire Fund to 58,573 in the Berkshire Fund, with broadly similar splits between active, deferred and pensioner members.
- Net cash flow associated with members was broadly comparable between Oxfordshire and Buckinghamshire (Oxfordshire figure for 2011/12 is distorted by inclusion of one-off deficit contribution). Cash flow for Berkshire was significantly lower, and went negative in 2012/13, reflecting the much lower average employer contribution rate set under the 2010 Valuation (16.5% compared to 19.0% for Oxfordshire and Buckinghamshire).
- Average rate of investment return as calculated by Barnett Waddingham was 5.6% in Berkshire, 7.6% in Buckinghamshire and 8.9% in Oxfordshire. Equivalent figures from the 2010 Valuation were -5.1%, +1.3% and -1.1% respectively.
- Actual discount rates applied by the actuary based on asset allocations were broadly similar, with Oxfordshire at 5.8%, and Berkshire and Buckinghamshire at 6.1%.
- Whilst discount rates were similar, and actual asset allocations were broadly similar between Oxfordshire and Buckinghamshire, Berkshire's figures show a much greater diversification.

Implications for a Potential Future Fund

Clearly the greater the similarity between the current funds, the lower the impacts on moving to a common fund. To that extent the similarities in fund sizes and member composition, average employer contribution rates, discount rates and cash flows (after allowing for the hike in the average Berkshire employer contribution rate) all reduce the impact on bringing together the Funds.

The lower Berkshire funding level, and the deficit recovery periods can both be managed, as these will be carried forward into a common approach. i.e. each employer within the three funds retains their current funding level, and can retain their current deficit recovery period, enabling the Actuary to maintain stable employer contribution rates going forward.

The key issue for a Joint Committee will be the greater diversification within the Berkshire Fund's asset allocation. Whilst this has not led to any differences in the discount rates calculated for each fund, this diversification away from more traditional equity allocations has impacted on actual investment returns over recent years. The Joint Committee will need to manage the impact of this as they develop common investment strategies across the three funds, both in terms of managing the cost of the transition and the movement towards common investment approaches.

One potential option for the Joint Committee will be to establish a Common Investment Fund (CIF) to hold all the assets of the three funds. The CIF will have sub-funds for each asset class held and the Joint Committee will be responsible over time for rationalising the number of fund managers and delivering the target savings. The Joint Committee could initially offer two investment strategies, one of which would be based around the more traditional strategies employed by Buckinghamshire and Oxfordshire, and one being a lower risk/higher diversified strategy, based around the current Berkshire strategy. Initial asset allocations to individual employers on day 1 of the Joint Committee could then reflect the composition of the asset allocation of their current fund. Over time, the Joint Committee would need to refine the risk and return parameters associated with both strategies, and agree any variations to the asset allocations commensurate with these parameters. The Joint Committee would also have the option of developing a lower risk strategy for employers deemed to have a weaker covenant, or those with higher funding levels looking to reduce future risk.

Appendix 2 represents this potential model in diagrammatic form.

Potential Operating Model

<u>Joint Committee</u>

The Potential Operating Model is predicated on the creation of a Joint Committee to which each of the three Administering Authorities delegates its full responsibilities in respect of the management of their Fund. Key amongst these responsibilities will be the establishment of the asset allocation for the three funds, which as noted above may comprise one or more investment strategies into which individual scheme employers can opt, to suit their financial circumstances and risk appetite. The Joint Committee will also be responsible for fund manager selection, investment monitoring and reporting.

The Joint Committee will be established under section 102 (5) of the Local Government Act 1972, and its constitution contained in a formal agreement entered into by the three authorities. The terms of reference would reflect the responsibilities contained in the terms of reference of the existing Pension Fund Committees, but would also need to prescribe the numbers of members which each authority could appoint, the terms of office, voting rights, the sharing of expenses, the process to wind up the arrangements and other related matters. To ensure a Committee of an appropriate size, and ensure proper representation from the three administering authorities, it is proposed that each authority nominates three members to the Joint Committee, to give a total Committee size of nine, with issues of political

representation balanced at full Committee level. The Joint Committee itself could be left to determine the issue of co-opted members, including scheme member representatives.

Pensions Board

Under the Public Services Pensions Act 2013, each Administering Authority must also establish a Pensions Board. The Board exists to assist the Administering Authority to secure compliance with the regulations, the requirements of the Pensions Regulator and other related legislation, and to ensure the effective and efficient governance and administration of the Scheme. It is expected that the final Regulations will allow for a Joint Pensions Board to be established where the functions of the Scheme Manager have been delegated in full to a Joint Committee. On the assumption that the final regulations do so allow, it is proposed to establish a Joint Pensions Board to comprise of one employer and one scheme member representative nominated by each of the three Administering Authorities, plus an independent chairman.

Advisory Panel/Consultative Group

There has been some discussion about the establishment of advisory panels or consultative groups in addition to the Pensions Board. This would enable for the wider engagement with scheme employers. As this would not be a statutory requirement, it is suggested that this is left for the new Joint Committee to determine once they have had the opportunity to assess the new arrangements, and in particular the developing role of the new Pension Board.

New Support Arrangements

Alongside the establishment of the Joint Committee and Joint Pension Board, the other key requirement is the determination of the support arrangements for the new model. The two potential options are the agreement to a Lead Authority or for the establishment of a new wholly owned company.

- Lead Authority. Under the Lead Authority model, staff from the remaining two authorities would transfer under TUPE to the lead authority. All new appointments would be made under the terms and conditions of the Lead Authority. The Lead Authority would be responsible for the provision of the full range of support functions, including legal and technical support, HR advice, the provision of suitable accommodation etc. It is likely that under such a model, the three Chief Finance Officers would establish a Partnership Board to have oversight of the management of the combined funds.

  It should be noted that for the administration teams who deal directly with scheme employers and members, there is very limited change in role in the short term. To minimise the risk of a significant loss of the current skills and knowledge held in these teams, and to minimise the impact on employers and employees, it is suggested that these administration teams retain their existing office basis. As such, these staff would not necessarily need to transfer to the Lead Authority, and this will need to be considered further as

part of any consultation exercise. Management of these teams though would come under a single management structure through the Lead Authority who over time would seek to standardise working arrangements based on best practice, allowing for a greater transfer of work between the teams, and if appropriate, a move to a single office base in the future.

- Wholly Owned Company. Under a wholly owned company model, the three administering authorities would establish the new company, supported by the ownership of shares in the company. The liability of the three authorities would be limited to the value of the shares owned, which could be as little as £1. The Administering Authorities would need to appoint directors to run the company, which could be the three Chief Finance Officers to oversee the management of the arrangements. As a company controlled by the administering authorities, there would be no requirement to run a procurement exercise before entering a contract with the company for the provision of administrative and investment services. The Teckal exemption would apply here, which covers where a contracting authority still exercises control over the company similar to that it has over its own departments, and where the company provides the essential part of its work for the contracting authority.

  Staff would transfer to the new company under TUPE in a similar manner to any transfer to a Lead Authority. As a new company, there would be greater freedom to establish new terms and conditions for future appointments. As a company controlled by the administering authorities, the new company would fall under Schedule 2, Part 2 of the LGPS Regulations 2013, and as such would be able to designate that staff have access to the LGPS.

Once up and running, there is little to choose between the Lead Authority and New Company models. The main advantages of the Lead Authority model are seen as the reduced cost and time associated with establishing the model, which are largely based on existing arrangements. Establishing a new company will require additional time and cost to establish the legal framework for the company, and make the necessary arrangements for the provision of all the support services and accommodation requirements. The main advantages of the New Company model would be in terms of future flexibility, particularly if the administering authorities were to determine to end the Joint Committee arrangements. As a wholly owned company, it may well be politically more acceptable for the company to continue to provide the full range of administrative and investment functions to the three administering authorities, rather than the Lead Authority continuing to be responsible for the provision of services to its former partners.

It would be possible to take a staged approach to the establishment of the support arrangements, with a move to a Lead Authority as an initial step, with a decision on incurring the additional costs and time of establishing a new company once the new arrangements have proven their potential.

If it is determined to establish a Lead Authority (either on a short term or permanent basis), it is important to determine the criteria by which the Lead Authority will be chosen. Key issues include:

- Complexity and strength of the support services. The Joint Committee would need to consider whether the fact that support services to Windsor and Maidenhead are provided through Shared Services arrangements or the fact that Oxfordshire is in the process of transferring the majority of its finance and HR support services to Hampshire would impact on future service delivery to a Lead Authority.
- Availability and Cost of suitable accommodation, including proximity to the major financial services in London. This latter point can be seen as an advantage in terms of dealing with Fund Managers, but may be a disadvantage when seeking to recruit and retain key investment professionals.
- Any recruitment and retention issues in respect of maintaining suitably qualified staff.

What does not change?

In covering the potential changes associated with greater collaboration, it is important to also highlight key issues that will not change. A key point here for scheme members is that nothing in these arrangements impacts on the statutory determination of their pension benefits. These remain the same irrespective of how the funds are managed.

Until such time as the Government sets up the legislative arrangements to allow the merger of administering authorities, it is also the case that the current administering authorities retain their ultimate role as the Scheme Manager even where they have delegated responsibility for all decisions to the Joint Committee. As such each of the administering authorities will still have to publish their own set of accounts, though these can be produce through the Lead Authority.

It will still be necessary for all liabilities and assets to be identified to individual employers. These will be amalgamated up to form the total liabilities and assets of the three administering authorities. .

The Future Road Map and Costs of Transition

If the direction of travel as outlined in this report is approved by the respective Pension Fund Committees, there will be a requirement to undertake a consultation exercise with key stakeholders. These stakeholders would include the scheme employers and scheme members, as well as the Department for Communities and Local Government. A two month consultation period would allow reports to be taken back to the respective Pension Fund Committee's in March for a final recommendation to full Councils in April.

If the Joint Committee was approved in April, the target for the establishment of the new Joint Committee would be July 2015. A decision would also need to be made at this time on the appointment of the Lead Authority, based on any feedback on criteria from the consultation exercise.

The project costs of establishing the new arrangements are estimated at no more than £300,000 which will cover all necessary legal and HR advice, and system

changes. As the majority of support cost savings are in consultancy services etc. redundancy costs should also be contained within this provision.

Whilst the savings in support costs should be achievable within the first year of operation of the new arrangements, it will be up to the Joint Committee to determine how quickly they move to a new investment strategy for the three funds as a whole. They will need to take into account the costs of transition whether between asset classes, or between fund managers, as well as the illiquidity of some of the existing assets held by the funds. The actual costs and savings will also be dependent on the nature of the asset allocation decisions made by the Joint Committee. Analysis of recent transition costs incurred by the three funds, as well as information reported by other LGPS funds suggests transition costs in the range 17 to 60 basis points, with the majority in the 20-30bps range. If 60% of the Fund was transitioned at an average cost of 30bps, this would suggest a 3 year payback period based on annual investment fee savings of £3m. It should be noted that the payback period is three years from the end of transition and not from today. The actual transition will be over a number of years, particularly in respect of the illiquid asset classes of private equity and property. Hymans in their report for the Government indicated full savings could take up to 10 years to achieve.

Conclusions and Recommendations

Whilst the Government has ruled out the option of fund mergers at present, the scale of scheme deficits, the level of employer contributions during this period of severe financial pressure within the public sector, and the need to protect scheme members from further reductions in benefits under the cost management arrangements does require us to continue to examine options for further improvements in the management of LGPS funds.

In our view, a key step for delivering these further improvements is to introduce much greater collaboration between funds, as a means of driving economies of scale, and allowing the limited resources at our disposal to focus on the key issues which drive scheme performance. This paper looks to set out proposals for the first stages of this greater collaboration and sets target savings in the region of £3.5m through the establishment of a Joint Committee and common investment approach across the three LGPS Pension Funds of Buckinghamshire, Oxfordshire and Berkshire.

Our analysis of the current funds suggests that there are sufficient similarities in terms of size, scheme membership, funding position and current discount rates to ensure that these potential savings are not achieved at the expense of the performance of any one fund or scheme employer. Potential costs for managing the transition are estimated at £300,000 plus the costs of transitioning investments to a common strategy. It is estimated that the payback period for any transition costs would be around 3 years.

In the longer term, we would look to deliver further improvements through looking at the potential for the internal management of parts of the fund, and through increasing the resources dedicated to improving the overall governance of the fund, as well as looking to expand the model to incorporate further LGPS funds.

At this stage, each Pension Fund Committee is recommended to endorse the approach, and initiate a consultation exercise based on the model outlined in this paper, with a view to making final recommendations to their respective full Councils in April 2015.