Collaboration on Pensions Management between Buckinghamshire County Council, Oxfordshire County Council and the Royal Borough of Windsor & Maidenhead.

Business Proposal
September 2014

Contents

Introduction	3
Review of the Options	4
The Proposed Option – Joint Committee	9
Options for the Finance and Administration Functions	10
Consultation Requirements	11
SWOT Analysis	12
Benefits	13
Timescale	14
Financial Analysis	15
Pensions Administration	16
Investments and Finance	19
Organisation Chart – Service Company	27
Risk Analysis	28

Introduction

In the summer of 2013, Officers presented to their relative Committees (both Pensions Committees and Cabinets) their paper on cost savings to be garnered from closer working. This paper gave 3 options:

1. A single combined Pension Fund with a single administering authority;
2. 3 Separate Pension Funds with a single administration team;
3. Collaborative working expanding on current practice;

and concluded that the preferred option was option1. Officers were mandated to meet with the Department for Communities and Local Government to ascertain their reaction to option 1 should the Councils wish to proceed with that option, and to work up a more detailed business case to support the preferred option.

This document provides the more detailed business case, including an amended option 1 for the creation of a Joint Committee to oversee the responsibilities of the three administering authorities of the Berkshire, Buckinghamshire and Oxfordshire Local Government Pension Scheme funds. Assuming that such a Committee is formed, it also considers two options for delivering the support to the Committee i) that the three separate pensions functions be subsumed into a single pensions services company to be equally owned by the three administering authorities and ii) services are providing by one of the current administering administration authorities acting as lead authority. Options 2 and 3 include the use of national procurement frameworks and common investment vehicles as an alternative means of delivering the savings associated with moving to a Joint Committee.

The proposal to amend option 1 is the outcome of detailed work by officers from the three authorities over the past three years. This has involved discussions with the Department for Communities and Local Government (DCLG), and the Local Government Association (LGA), who suggested the Joint Committee route to be an alternative way forward in the absence of any current will to take forward the new legislation required to support a full scheme merger.

At their meeting with the Department officers were advised that to combine the three funds into 1 with a single administering authority would require a statutory instrument to be laid in Parliament to amend the Local Government Pension Scheme regulations. Officials stated that there was no available time in the current Parliament to lay such a regulation. However, they suggested that to all intents and purposes option 1 could be achieved by agreement to form a Joint Committee to manage the three funds as one. This guidance has been incorporated into this business proposal.

Review of the Options

Since the initial joint report from the Officers there has been considerable discussion nationally on future arrangements for the management of LGPS funds in England and Wales. This included the Call for Evidence launched by DCLG, the study undertaken by Hymans Robertson on behalf of DCLG and the Cabinet Office, and the recent consultation paper which focussed on common investment vehicles and switching management of listed equities from an active to a passive basis. The options identified in the initial paper have therefore been reviewed again in light of these further developments.

A view coming across from a significant number of the consultation responses, was that the Government's consultation focussed too heavily on cost savings, and not sufficiently on the potentially much more significant benefits associated with improving investment performance, where current figures show a wide dispersion of results. There was though general agreement that the potential savings resulting from a focus on scheme administration were insignificant compared to those on the investment side.

The key issue therefore in reviewing the current management arrangements across the three funds were to the extent to which change would lead to greater net investment returns as a means to reducing the current fund deficits. The Hymans Roberson report identified a number of factors common across the best performing funds being:

- Limited number of managers
- Retain managers for the long term
- Adopt simple structures focussed on equities, bonds and property
- Limited use of alternatives
- Some use of internal management
- Regular re-balancing to asset allocation benchmark

Other research quoted the performance benefit associated with good governance, with figures of 1% out-performance reported as a consequence of a well governed fund.

Whilst size was not seen to directly relate to fund performance, a number of writers have linked size to a number of the other factors, particularly around the size and skills of the in-house investment teams which can lead to both improved governance and greater use of direct in-house investment.

The key question therefore is how the Funds of Buckinghamshire, Oxfordshire and Berkshire best meet the characteristics of a good performing fund. Arguably, all the factors identified by Hymans (apart from the scale of internal management) are independent of size, and can be delivered by the existing funds within their existing structures i.e. under option 3 above.

Whilst the research material is inconclusive on the issue of size and actual fund performance, there are a number of research papers which take the view that larger funds have the potential to out-perform smaller funds. For example, State Street Investment Analytics (who undertake performance management across most of the LGPS funds) in their research paper “Do Larger Funds Perform Better?” published in September 2013 identified the following benefits a larger fund size confers in terms of improving returns:

- Potential to reduce investment management costs
- Potential to consider internal management
- Potential for better governance

The paper identifies average investment management costs as 23 basis points (bps) for larger funds (£5bn and above) compared to 38bps for smaller funds (£1bn and below). The average investment management costs of medium sized funds (£1bn-£2bn) consistent with the current size of the Buckinghamshire, Oxfordshire and Berkshire Funds were shown as 29bps in the paper, suggesting a saving in the region of 6bps or £3m per annum.

The average investment management cost of an internally managed fund in the same survey is 10bps, with almost all funds where at least two thirds of the fund is internally managed being over £5bn. The extent to which a combined fund could switch to internal management therefore suggests further potential savings of up to 13bps, or a further £6.5m per annum.

These savings which are potentially delivered through the revised option 1 are considerable greater than the conservative £2.25m per annum included in the initial joint report, and make no allowance for any additional savings from the potential for better governance. State Street define better governance as a greater focus on fund strategy relative to liabilities, and a true long-term approach to scheme investments.

This paper does not consider the question of a greater allocation to passive mandates, as many of the consultation responses indicated that simply switching to passive to save fees was not an appropriate solution, and all funds should retain the right to consider their relative allocations to passive and active management. If the Government choose to impose a greater allocation to passive investment on all LGPS funds, the financial impact in terms of fund manager fees is likely to be similar across all options as

the current low level of fees charged and the scale of assets under management make it unlikely that further fee reductions could be negotiated.

The question following on from the Government's recent consultation exercise though is whether such savings can be delivered through an alternative to "merging" the three funds. More specifically, can similar savings be made through common investment vehicles or procurement frameworks?

There is some difficulty in evaluating the potential benefits of common investment vehicles, as the potential structures of these common investment vehicles has not yet been determined. The first common investment vehicle in the LGPS is likely to be the one being developed by the London Councils on behalf of the 32 London Boroughs. The business case for the CIV suggests total benefits of £120m if the full £24bn of assets held by the London Boroughs is managed through the CIV. This equates to 50bps and comprises both fee savings and improved investment returns through improved governance. At the present time, asset allocation decisions will remain with the individual boroughs, and funds will be externally managed. The London CIV is being developed specifically to benefit the London Boroughs, but it is hoped that it will be opened up to LGPS funds outside London at a future time.

The main concern with the CIV model is around governance and asset allocation decisions, and the potential conflict between the freedom of the individual administering authorities to select their own fund managers, and the CIV who will be pushing for the rationalisation over time of the current mandates to allow for the economies of scale. The potential savings are predicated on a full investment through the CIV. Whilst the potential benefits through economies of scale are at least consistent with those by moving to a larger fund, the governance structure introduces a risk of the sustainability of the benefits, as individual funds can choose to withdraw assets at any point.

For Buckinghamshire, Oxfordshire and Berkshire, the short term issue is where and when the opportunity to invest through a CIV will arise. Whilst the London CIV may allow investments from LGPS Funds outside London, it is also the stated position of the London Councils that a single CIV for the whole of the LGPS is likely to generate dis-economies of scale and could be potentially disruptive to the investment market. The difficulties of setting up a CIV through which the three Councils could invest should not be under-estimated (as can be evidenced by the timescales involved in establishing the Pensions Infrastructure Platform). It should also be noted that the current investment strategies of the three Funds differ both in terms of asset allocation and fund managers. If the three Committees retain their current investment strategies then the CIV or CIVs will need to be greater than simply the three funds to generate the same levels of economies of scale.

The benefits of National Procurement Frameworks should also be considered as an alternative to a merged fund. Again, there are currently no investment management frameworks to evidence the potential savings, but the expectation would be that the savings under a national procurement framework would be at least the same as those negotiated by the larger funds.

The issues with national procurement frameworks as an alternative to a "merged" fund are similar to those with CIVs. Firstly they are dependent on individual funds agreeing to move towards a consolidated number of investment mandates and fund managers. Secondly, no investment management frameworks currently exist, so there needs to be an agreement as to who will establish and manage these frameworks. Thirdly, use of national procurement frameworks will not address the current governance deficits at individual pension fund level. Finally, whilst CIV's can move towards internal management over time, national procurement frameworks are purely focussed on the economies of scale and the ability to reduce investment management fees over time, and as such cannot deliver the same level of savings as the other two options.

In summary therefore we see the financial benefits of the three options as follows:

	Potential to Reduce Investment Management Costs	Potential to Consider Internal Management	Potential for Better Governance	Total Potential Savings*
Joint Committee – Shared Investment Strategy, and Administration.	Economies of scale from increased fund size could deliver investment management fee savings of 6bps or £3m	Based on the analysis of State Street, a fund of £5bn would have potential to consider internal management with additional potential savings of up to 13 bps or £6.5m	Economies of Scale would allow for a higher proportion of budget to be allocated to improving governance of Fund. Better governance has been found to add 1% or £50m to investment returns.	Minimum savings of c £3m through economies of scale through moving to single investment strategy, with potential for further savings of up to £6.5m from internal management and more from better governance.
Individual Committees – Individual Investment Strategies and Shared Administration	Economies of Scale would have to be realised through a CIV or National Procurement	Individual Committees would remain too small to support internal management	Not within existing resources, and retention of separate investment strategies.	Would be dependent on the establishment of suitable CIV's and/or National

	Framework. Assuming these were established, then similar savings should be possible i.e. £3m	arrangements. Could gain similar benefits dependent on basis of CIV, but not through national procurement route.		Procurement Frameworks outside the direct control of the three Funds. If suitable CIV's established then potential to deliver similar total savings, but governance savings would be at higher cost.
Individual Committees – Individual Investment Strategies and Administration Arrangements Retained	Economies of Scale would have to be realised through a CIV or National Procurement Framework. Assuming these were established, then similar savings should be possible i.e. £3m	Individual Committees would remain too small to support internal management arrangements. Could gain similar benefits dependent on basis of CIV, but not through national procurement route.	Not within existing resources, and retention of separate investment strategies.	Would be dependent on the establishment of suitable CIV's and/or National Procurement Frameworks outside the direct control of the three Funds. If suitable CIV's established then potential to deliver similar total savings, but governance savings would be at higher cost.

*There are further savings associated with costs of administration support and consultancy advice etc as set out in the financial analysis below. These are estimated at £463,000 for the Joint Committee option (against a one off cost of c £500,000). None of these savings would accrue if the third option to retain individual investment strategies and administration arrangements was followed, whilst £141,000 of these savings could be potentially made if administration was shared under option 2.

We therefore remain of the view that the greatest potential savings will come from option one and the establishment of a Joint Committee, which as well as addressing under our own control the benefits of economies of scale in terms of investment mandates, allows consideration to be given to internal management and will allow for an improvement in the current governance budget. The alternative options of joining a common investment vehicle or a national procurement framework are currently not available, and even if they are developed, do not offer the same governance benefits, or the same reductions in staffing and consultancy support etc, and as such limit the overall level of savings achievable.

The rest of this paper therefore focuses on the proposal to move to a Joint Committee.

The Proposed Option – Joint Committee

The proposal is that the three administering authorities agree to form a Joint Committee to manage the functions of an administering authority on behalf of Buckinghamshire County Council, Oxfordshire County Council and the Royal Borough of Windsor & Maidenhead. Such a Joint Committee would be established under section 102 (5) of the Local Government Act 1972.

Under the provisions of the Local Government Act 1972 and the Local Government and Housing Act 1989 the three authorities can agree to delegate their functions as Scheme Manager to the Joint Committee. The Joint Committee would be responsible for asset allocation, fund manager selection and investment monitoring and reporting. It should be noted that whilst the Joint Committee would have delegated powers, the formal Scheme Manager under the relevant regulations would continue to be the three Administering Authorities of Oxfordshire and Buckinghamshire County Councils and the Royal Borough of Windsor and Maidenhead.

The constitution of the Joint Committee would need to be contained in the formal agreement entered into by the three authorities. The agreement would also prescribe the number of members which each authority may appoint, the terms of office, voting rights, the sharing of expenses and other related matters. We would propose that each authority nominates three members each to the Joint Committee to give a total Committee size of nine, with political representation balanced at full Committee level.

We would also propose that the Joint Committee is supported by a Consultative Group which would sit outside the formal statutory arrangements, but would exist to allow a wider representation of employer views to be considered. Each Administering Authority would be invited to nominate 5 members to the Consultative Group. The determination of these nominations would be a matter for each administering authority, and should be considered further in light of consultation feedback from the current scheme employers.

In addition to the Joint Committee, each Administering Authority must also establish a Pensions Board. As part of the consultation of the draft regulations, the Department for Communities and Local Government have asked for views on the establishment of a joint Pension Board where Administering Authorities have delegated their functions as Scheme Manager to a Joint Committee. It is assumed that any final decision would require the approval of the Secretary of State. On the assumption that the arrangements for a Joint Pension Board are included in the final Regulations, it would be our intention to seek Secretary of State approval for the establishment of a single Pension Board for the three Administering Authorities, and to avoid the need to establish separate Pension Boards from April 2015 in any interim period before the Joint Committee is established. If approval was forth coming, our proposal would be to establish a Pension Board of seven members, being one employer and one employee representative nominated by each of the three administering authorities, and an independent chairman.

Options for the Investment and Administration Functions

As part of the work on this business case, three options were identified for the delivery of the investment and administration functions to support the work of the Joint Committee, being

- Out-source the work to a private organisation
- Appoint one of the three administering authorities to act as Lead Authority
- Create a new wholly owned company to run the functions.

Out-sourcing to a private organisation was dismissed early in the appraisal on financial grounds due to the loss of taxation benefits associated with operating within the local authority framework, and in particular the ability to reclaim VAT which amounts to c£1.8m in respect of investment management fees alone across the three funds.

The main advantage of the Lead Authority option was seen to be a potential saving in terms of both cost and time in establishing the new arrangements. However the ability to establish a new company through the purchase of an "off the shelf" model with standard articles of agreement etc mean these potential savings would not be significant.

There are a number of concerns with the Lead Authority option. Firstly, a Lead Authority creates potential tensions as by definition there is a senior partner and two junior partners. Whilst the arrangements can stipulate how the junior partners can retain an element of influence and control, There will always be the underling risk of perception of bias or undue influence. A new company wholly owned by the three administering authorities in equal shares avoids such issues.

A second concern is in respect of the management of the staff transfer. Whilst the staff would all transfer under TUPE on their existing terms and conditions, we would be looking for the harmonisation of terms and conditions to avoid the situation where staff undertaking identical roles are operating on different terms and conditions. This would be easier to achieve with the flexibility of a new company and the option for new terms and conditions, rather than seeking to harmonise within the standard terms and conditions of the lead authority.

The third concern with the Lead Authority model is how the model is unpicked in the event that the Joint Committee arrangements cease, and the three Administering Authorities revert to working independently. Unless the two junior authorities were happy to continue to have their investment and administrative support provided by the Lead Authority, they would be faced with the need to recruit back to their independent teams. Whilst the Lead Authority could well retain the high skills and experience built up over the operation of the joint arrangements, staff grades are now likely to be in excess of those applicable to a smaller fund, and any internal fund management arrangements may no longer be sustainable. It is likely, that in the event of a future return to three independent Pension Committees, purchasing support services from a standalone company wholly owned by the three administering authorities would be seen to be acceptable.

The proposed way forward therefore would involve the establishment of a wholly owned company, limited by shares, to support the work of the Joint Committee.

Wholly Owned Company, Limited by Shares

As noted above, a wholly owned company limited by shares can be established through the purchase of an existing “off the shelf” model. As a separate entity the company can own property, employ staff, enter contracts, and sue and be sued. The three administering authorities would own shares in the company, and their liability would be limited to the value of the shares owned. This could be as little as £1. There would be additional obligations on the new company to produce and provide to companies House a set amount of information on an annual basis.

Shares would not need to be offered to the general public, and as a private limited company the reporting obligations to Companies House are not as onerous. The Administering Authorities would need to appoint Directors to manage the company.

As a company controlled by the administering authorities, there would be no requirement to run a procurement process before entering a contract to provide the investment and administration services, under an exemption often referred to as the Teckal exemption. The Teckal exemption applies when a contracting authority still exercise control over the company that is similar to the control it has over its own departments, and the company provides the essential part of its work for the contracting authority.

The existing staff in the three administering authorities employed to provide investment and administration support would transfer to the new company under TUPE. As noted above, under TUPE all staff transfer on their existing terms and conditions, but we would propose to undertake a harmonisation of these terms and conditions (all three authorities currently operate their own local pay arrangements) at no detriment to the staff. As a company controlled by the administering authorities, the new company would fall under Schedule 2 Part 2 of the LGPS Regulations 2013, and therefore would be able to designate that staff have access to the LGPS.

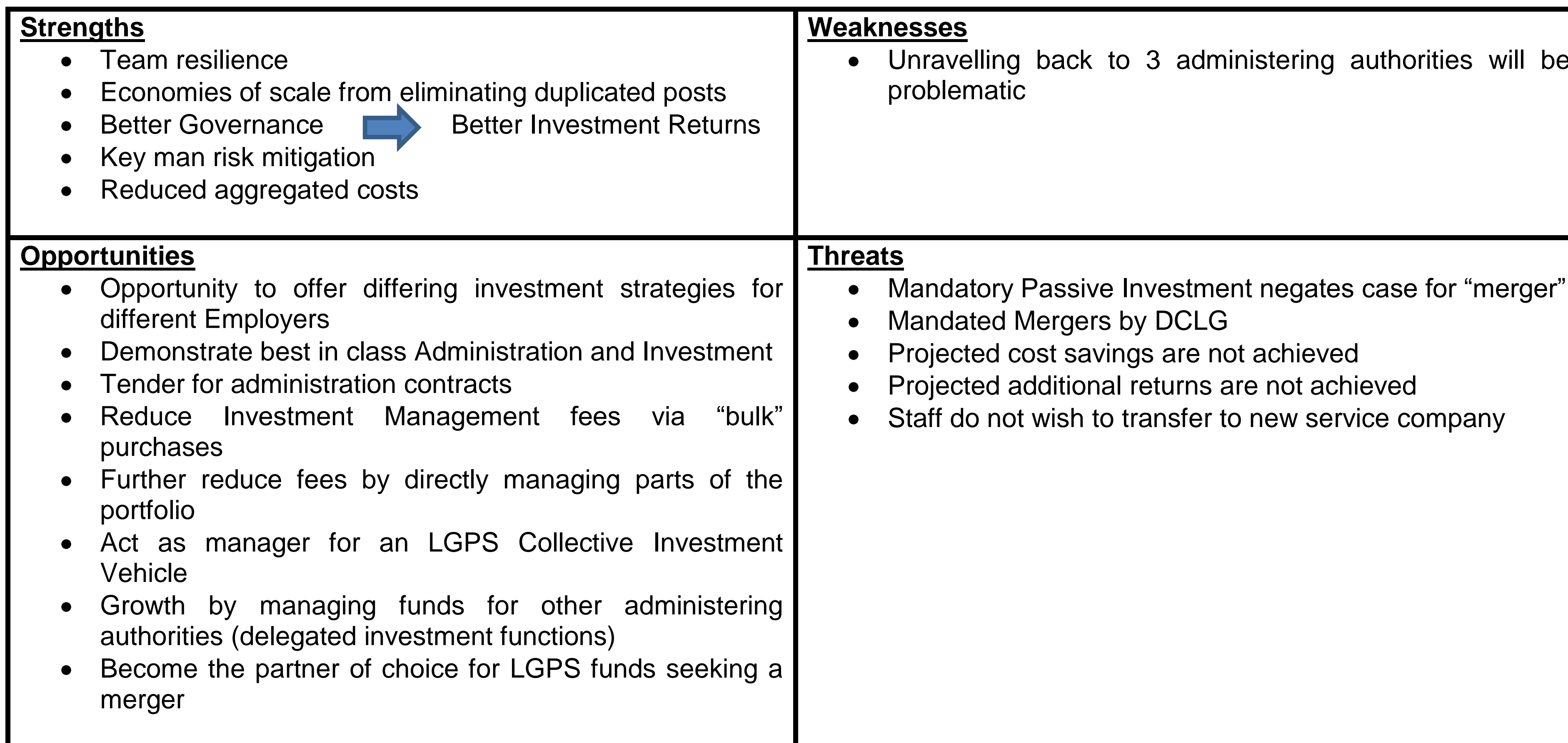
Consultation Requirements

Given the nature of the proposed changes, there would be a requirement to undertake two consultation exercises. The first would be with key stakeholders under the current arrangements (including current scheme employers and scheme member representatives) to establish their views on the proposals before a final decision is made. It is proposed that each of the three administering authorities undertake their own stakeholder consultation on the principles set out in this document, and all responses are then incorporated into the final report to the current administering authorities.

A separate consultation will also need to be undertaken with the staff impacted by these proposed changes. This consultation will need to focus on the specific impacts for staff and include information on the new structures, any changes to job roles and the process for filling new positions, whether it be by interview or a slotting in process. As the consultation is on a single new structure, the consultation process should be common across all staff. Any feedback from the staff consultation process also needs to be fed back into the final report to the three administering authorities.

SWOT Analysis

A popular tool used to assist businesses in their planning is a SWOT (Strengths, Weaknesses, Opportunities and Threats) analysis which is shown on the following page. The analysis compares the proposed model against the status quo, with many of the strengths and opportunities also relative to the options 2 and 3 above.



Strengths	**Weaknesses**
• Team resilience • Economies of scale from eliminating duplicated posts • Better Governance → Better Investment Returns • Key man risk mitigation • Reduced aggregated costs	• Unravelling back to 3 administering authorities will be problematic
Opportunities	**Threats**
• Opportunity to offer differing investment strategies for different Employers • Demonstrate best in class Administration and Investment • Tender for administration contracts • Reduce Investment Management fees via “bulk” purchases • Further reduce fees by directly managing parts of the portfolio • Act as manager for an LGPS Collective Investment Vehicle • Growth by managing funds for other administering authorities (delegated investment functions) • Become the partner of choice for LGPS funds seeking a merger	• Mandatory Passive Investment negates case for “merger” • Mandated Mergers by DCLG • Projected cost savings are not achieved • Projected additional returns are not achieved • Staff do not wish to transfer to new service company

Benefits of this proposal

The key benefits of this proposal are:

1. Economies of scale in administration (£0..463 saving see below)
2. Lower management fees (£1.5m-£3m saving)
3. Ability to generate higher returns through better investment governance and internal management
4. Staff resilience
5. Risk mitigation

6. Opportunity to develop alternative investment strategies based on employer risk appetite and funding position

The amalgamation of these benefits should result in:

1. Reduced pressures on Council Tax as costs are reduced and net returns increased
2. Protection of Member Benefits which would also be threatened under the cost management arrangements to cap the overall increase in employer contributions.
3. A more resilient pensions service benefitting members and all other stakeholders.

Timescale

Officers recommend that should this proposal be adopted the Joint Committee assumes responsibility for the three funds on 1 July 2015. On the same date the day to day management of the funds would be transferred into a service company by the transfer of relevant staff. This transfer would be in accordance with the TUPE regulations. An indicative timeline is shown below.

a) Formation of Joint Committee and creation of Service Company

Period	**Action**
September & October 2014	Business Proposal presented to Pension Committees for approval
October – December 2014	Stakeholder and employee consultations
January 2015	Approval sought from Councils for formation of Joint Committee
May 2015	First meeting of Joint Committee to approve formation of service company and appointment of senior officers
1 July 2015	Staff transfer to service company which takes on responsibility for managing the 3 funds

b) Staff Transfers to Service Company.

Period	**Action**
May 2015	Service Company appoints HR advisor
May 2015	Joint Committee appoint senior officers to Service Company (Chief Executive, Investment Director, Pensions Administration Manager, Business Manager)

April - June 2015	Administering authorities consult with staff
May - June 2015	Service Company issues “at risk” notices (if required)
June 2015	Administering authorities issue transfer letter
1 July 2015	Employees transfer to Service Company
Mid July 2015	Redundancy notices issued

Financial Analysis

a) Management Fees

A lot of the Government’s focus has been on cost reduction, with an emphasis on passive rather than active management fees, which does not take into account the net additional benefit active management can bring. Although there are not currently many mandates that are directly comparable across all 3 funds, a simple analysis of the investment mandates of the 3 existing funds indicates that a saving of at least £1.7m could be achieved if the lowest existing base fee were applied wherever there are similar mandates. This does not take into account increased mandate discounts that may be applicable or additional savings that could be generated as a consequence of consolidating mandates across the 3 funds in line with a single new investment strategy agreed by a Joint Committee. This indicates that the £3m saving potential saving identified on the basis of the State Street report is deliverable in this case.

b) Administration Costs

There are also opportunities for savings in the administration costs of a joint fund approach. Even if all existing staff were retained for a period to reduce any initial risks and to enable an effective development and implementation of process improvements, there would still be reasonable savings to be achieved through the joint administration approach almost immediately. The areas where savings could be made as a result of duplication are:

Senior Management Costs of the Administering Authorities (£111k)
Committee Advisers/Investment Consultancy (£215k)
Committee Services (£39k)
External/Internal Audit (£50k)
Performance Management Services (£18k)
Altair (Pensions Administration) System (£30k)

The above savings would be in the order of £463k, before taking into account any structural efficiencies that could be achieved over the medium term once uniform processes and procedures are in place across the whole joint administration function.

The cost of implementation should be no more than £500k covering Consultancy Costs, Legal Advice and setting up new systems.

Pensions Administration

Justification for merging the Pensions Administration Teams

Currently each administering authority has its own pensions administration team (located in Maidenhead, Aylesbury and Cowley). Whilst each team uses the same administration software ("Altair") the productivity of each team varies as shown in the tables below:

Members per fte staff				
	Berks	**Bucks**	**Oxon**	**Combined**
Actives	1550	1143	851	1107
Deferreds	1264	862	580	829
Pensioners	886	679	405	605
	3700	2684	1836	2541

2010/11 Annualised Tasks per Staff				
	Berks	**Bucks**	**Oxon**	**Combined**
Starters	265	170	132	175
Leavers	236	128	167	170
Retirements	68	48	33	46
Estimates	182	95	22	83
ARC's	15	2	5	6
Transfers In	36	14	25	24
Transfers Out	36	34	18	27
Divorces	11	7	5	7
Deaths	30	19	18	21
Changes	402	291	172	264

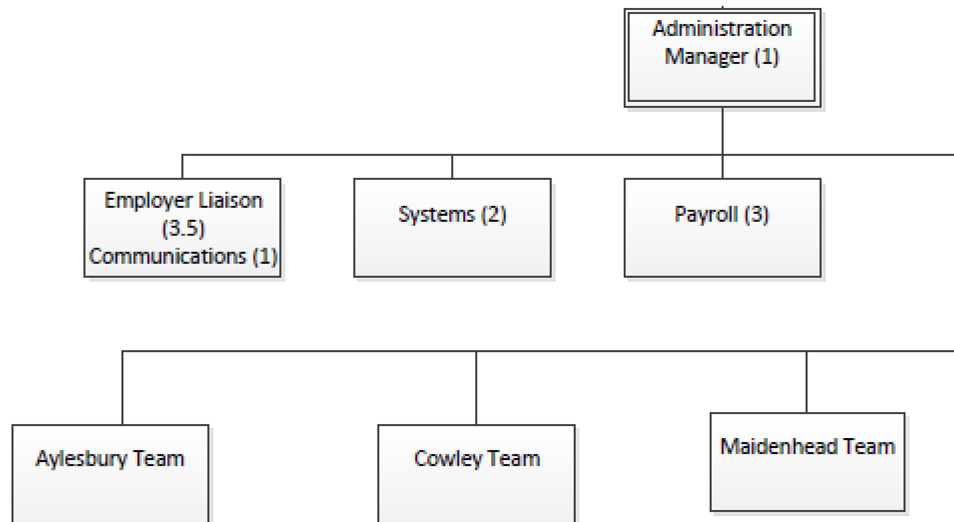
	1282	808	596	824

It is clear that there is a wide disparity in productivity between teams – to a certain extent this can be explained at the “task” level by tasks being defined differently or split into differing stages (which may or may not be recorded separately). Nevertheless there are opportunities to combine and rationalise teams with an overall objective of reducing the administration cost per member. In the first place there is considerable duplication at the management level and with peripheral services such as systems updating and management, payroll service, communications and training where a single team (or individual) could easily service all three teams. This elimination of duplicated services will rapidly result in a reduction in costs as included in the financial analysis above.

In the medium term it is intended that all three teams will adopt the best practice for each task thereby increasing overall productivity levels and facilitating transfer of work between teams to deal with the inevitable “ebbs and flows” that small teams face.
It is proposed that the Pensions Administration Manager together with payroll, communications, systems management and other peripheral services will be located at a single location and only pure administration (processing member records, dealing with enquiries, calculating benefits) will be retained at the other two offices which would be managed by a team leader. Over time as staff turnover progresses recruitment would be into a central location with the ultimate objective that the satellite offices will eventually be closed.

All post will be directed to a single location scanned and allocated to administrators on a daily basis. An Administration Manager would be responsible for monitoring and managing workloads. Thus over time teams will gain exposure to members based in other counties than the one they are based in.

It is intended that once agreement is reached to form a Joint Committee a full Project Plan will be developed to ensure that there is a smooth transition to a shared service. Key to this will be the appointment of an Acting Pensions Administration Manager whose primary objective would be to select best practice from across the three authorities and develop procedures that all administration staff would follow thus ensuring common practice in all three offices thereby facilitating the movement of work between offices.
The proposed staff structure is shown in the organisation chart overleaf:



Opportunities
The principal opportunity is the ability to reduce costs by:

- Utilising best practice across all three authorities to gain operational efficiencies
- Generating efficiency savings by consolidating services such as systems maintenance, payroll and communications

In the medium term by demonstrating lower administration costs per member the combined operation could:

- Bid for administration contracts as a Third Party Administrator as administering authorities seek to reduce their own costs.
- Offer a pensions administration service to other administering authorities wishing to consolidate their fund with a larger and more cost effective fund.

Next Steps
Following the creation of the Joint Committee and appointment of senior Officers the projects that will need to be completed prior to full integration of the three funds will include:

- Appointing staff
- Renegotiating contracts with Heywoods (administration software provider)
- Redirecting post to a single “scanning” centre
- Agreeing common work flows
- Integrating payroll into a single unit with a common pay date
- Consolidating communications (in particular creating a single brand, web-site and printed materials)

Investments and Finance

Justification for a merged Investments and Finance Operation

There have been many studies demonstrating that good investment governance leads to better investment returns after costs. The oft quoted figure is that this increase can be of the order of 1% per annum (equivalent to around £50 million for the combined fund) but for the purposes of this business plan we assume a conservative 0.5% or £25 million per annum of added value (i.e. over and above index returns) can be achieved. This is over and above any fee savings achieved.

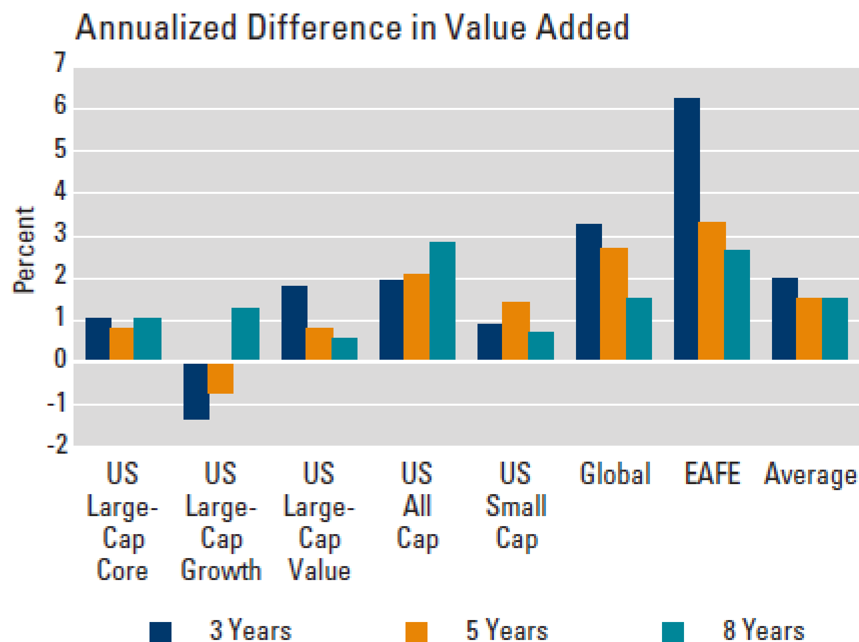
This additional return can be achieved by ensuring that the investment team is adequately resourced to effectively manage a £5.5 billion fund and that members of both the Joint Committee and the Pensions Board have a good understanding of investments. In the proposed structure we recommend that a highly experienced individual with a broad knowledge of differing asset classes be appointed as the Investment Director and he/she is supported by a team of 5 with varying degrees of experience. The Investment Director would focus on asset allocation and reviewing new investment opportunities whilst the other members of the team would be responsible for monitoring existing managers and reporting (with recommendations as necessary) on the performance of the existing managers as well as identifying potential new managers for the Fund.

Whilst it is outwith the remit of this plan Officers are confident that additional value add will be gained by employing, for at least part of the Fund, managers who follow a high conviction strategy. For instance Baillie Gifford who is an existing manager for Oxfordshire has added a net 1.6% per annum over the past decade whilst research commissioned by RBWM showed that high conviction managers add value over time as the table below shows:

	Highly Concentrated	Concentrated	Diversified	Highly Diversified
Value Add % p.a.	1.96%	0.53%	-0.55%	-1.94%

Source: Inalytics Ltd, Research Note 07, March 2013

This is further supported by research from Wellington Management where conviction was measured by a measure known as "active share" (in essence a measure of how much the portfolio varies from an index where 100 implies that no index constituents are held and 0 means that a portfolio exactly matches an index):



Investing in high conviction managers does require an investment team with sufficient resource to understand the manager's investment thesis, monitor performance and have sufficient expertise to be able to challenge managers should performance fade.
If we make a conservative assumption that a portfolio of such managers can add 1% per annum to net returns and that 20% of the Fund's assets are in such funds the value add would be in the region of £10 million per annum. A similar amount could also be achieved by using high conviction unconstrained mangers for bonds.

In the medium term, and subject to Joint Committee approval, it would be possible for the investment team to manage directly parts of the equity and bond portfolios thereby eliminating some fund management fees and bolstering net returns.

Another large potential net gain (although it would take some time to achieve) is in the field of private funds. Currently the majority of the 3 funds investments in private equity are via funds of funds where typically the fund of fund manager will levy a management fee of 0.65% per annum. A substantial proportion of this fee could be saved if the combined Fund had sufficient resources to make (and monitor) investments directly with individual private equity firms. In the longer run performance fees would also reduce as there would be less "carry" paid to fund of fund managers.

Finally a strong investment team would be in a position to review and recommend investments in under researched or more complex strategies which are "off the radar" screen for smaller funds reliant on their investment consultants.

The table below gives an indication of the magnitude of additional returns that could be achieved by having a strong investment team with the ability to analyse "active strategies". These additional returns are expressed in terms of additional expected returns over the long term (10 years).

Asset Class	**Range of Additional Return**	**Conservative Estimate**	**Possible Weighting**	**Additional Return £m p.a.**	**Notes**
Listed Equities	1-5%	1%	20%	10.0	Part of portfolio invested with high conviction managers
Private Equity	0.5-1.0%	0.5%	5%	1.25	Reduction in Fees by not using funds of funds
Specialist Global Bonds	1-2%	1%	10%	5.0	
Illiquid Credit Strategies	3-7%	5%	5%	11.25	Driven by complexity and illiquidity premia
Specialist	1-2%	1%	5%	1.25	e.g. Residential, opportunistic funds

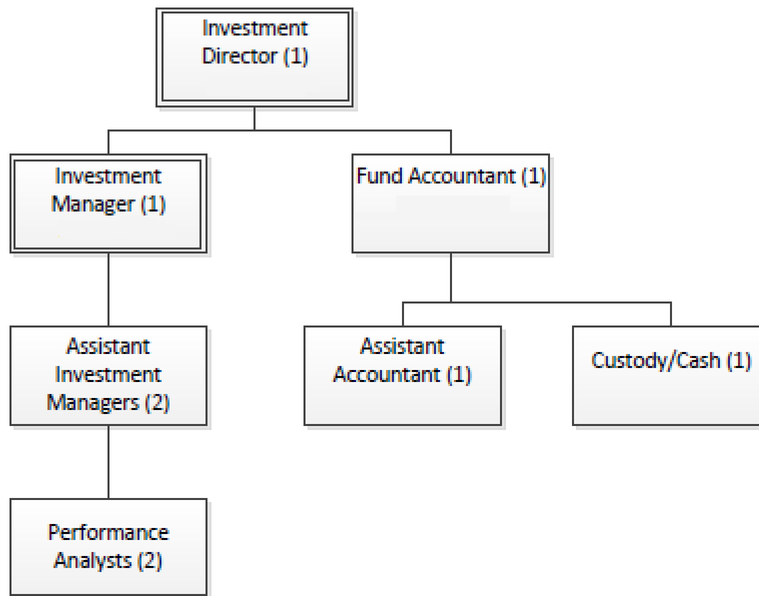
Property					
“Bulk Discount” on active management fees	0.0-0.20%	0.1%	50%	2.5	
Asset Allocation Monitoring	0-0.5%	0.1%	Whole Fund	5.0	Better timed implication of asset allocation changes (not tactical asset allocation)
Total				36.25	Equivalent to 0.725% per annum

These figures are illustrative only and much will depend on the investment strategy followed by the Fund.

At the same time, however, it will be important that the Joint Committee and the Pension Board receive adequate training to ensure that they are in a position to judge the suitability of recommendations that the investment team will make.

Staffing

The organisation chart overleaf shows the proposed staffing for the Investment and Finance team for the Service Company.



The team will also include the accounting and ancillary financial services for the Fund (overseeing custody relationships, treasury management and managing cash-flows).

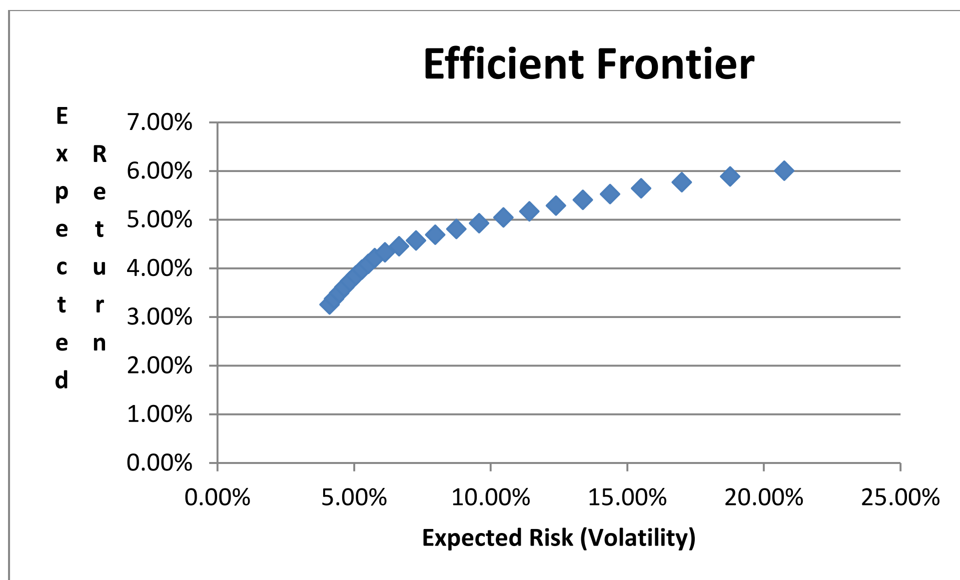
This structure will in aggregate provide a more robust team for the combined operation than any of the three administering authorities currently have as stand alone operations

Opportunities

The combined value of the three funds is around £5.5 billion spread across a wide range of asset classes and fund managers.
One of the advantages of having such a sized fund is that it will be able to offer employers a choice of investment strategies appropriate to both the size of the employer but also its ability to tolerate risk. Thus employers will be able to decide at a local level the strategy they wish to be invested in rather than the current one size fits all. At the current time our thoughts are that two or three strategies could be offered:

A) Higher Risk – invested in higher risk/higher return assets taking advantage when available of the illiquidity premium. Asset classes that could be included are equities (“high” alpha strategies), private equity (single funds, co-investments), infrastructure (with a capital growth bias), commodities, property (capital growth orientation), hedge funds (individual holdings). Such a strategy would be more appropriate for employers with a strong covenant, and low maturity (i.e. higher percentage of active members relative to deferred members and pensioners)
B) Lower Risk – equities (focus on lower risk products), fund of funds private equity, income orientated property (including residential), fund of funds hedge funds, income orientated infrastructure (i.e. focus on mature projects), bonds, index-linked gilts and convertible bonds (bonds with an equity related upside). Such a strategy would suit employers with high levels of maturity or a short term admission into the Fund
C) Medium Risk – an amalgam of strategies A and B offering employers a “halfway house” and would be the default option.

There are a number of ways that can be used to establish the mix of assets within each strategy. The most common way (albeit with several heroic assumptions being made) is via the use of an “efficient frontier” – to create an efficient frontier 3 items of information are required: expected return and volatility and the correlation of returns between each asset class. This information is input into a “mean variance optimiser” to create a set of portfolios which offer the highest expected return at specific levels of risk. The chart below prepared by JP Morgan Asset Management using RBWM’s expected returns and JP Morgan’s volatility and correlation assumptions shows, as should be expected, that higher returns require greater risk to be taken. (Note that expected returns are in excess of inflation).



The Fund's investments in each asset class would be "unitised" and each strategy would hold units in the requisite asset classes. Employers would be able to select which strategy they wish to be in although the Joint Committee would have the final say (for instance if an employer with a weak covenant and a large deficit was to select the higher risk capital growth strategy but the Committee though the lower risk strategy would be preferable for the common good of all employers). It should be noted that at this stage this is only a suggestion (but one with considerable merit) and much work needs to be done on implementation particularly with respect to the mechanics of unitisation and ensuring that cash flows are managed effectively.

Looking further ahead by developing a well resourced investment team and establishing sub funds the combined operation will be in a strong position to act as an investment expert for the LGPS and potentially to offer investment services including the management of collective investment vehicles to other LGPS funds.

Next steps

Following the creation of the Joint Committee and appointment of senior Officers the projects that will need to be completed prior to full integration of the three funds will include:

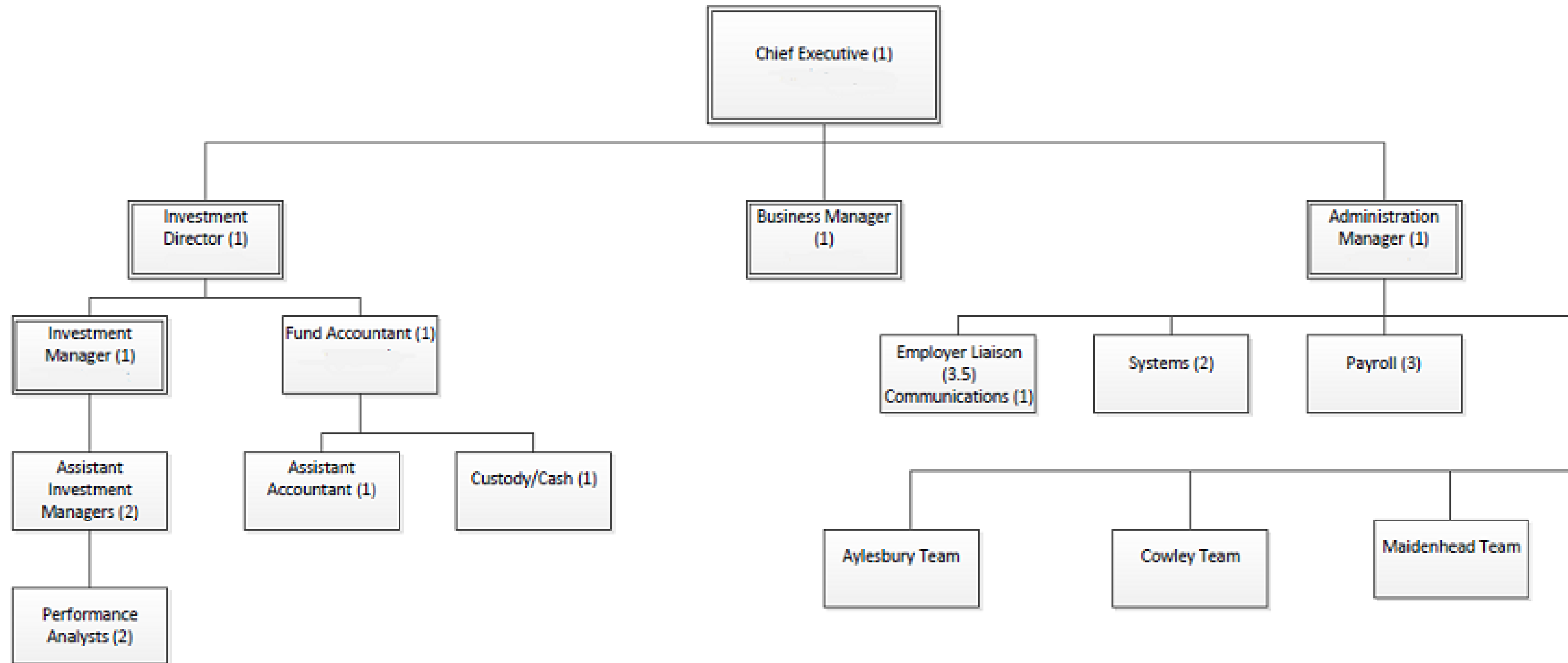
- Appointing staff
- Agreeing investment strategies with the Joint Committee

- Consideration to the forming an Investment Sub Committee
- Appointment of Independent Investment Advisers
- Designing investment mandates and tendering for managers (via framework agreements to facilitate changes in managers)
- Tendering for a single global custodian
- Merger of funds and implementing new investment strategies

Time Scales
Assuming that the Joint Committee comes into effect on 1 July 2015.

Period	Action
July- October 2015	Consult with employers on attitude to risk and preferred investment strategies
July – December 2015	Formulate Investment Strategies
January 2016 - October 2016	Tender for managers as required
October- November 2016	Agree with Actuary discount rates for each investment strategy
December 2016	Appoint new managers as required
January- February 2017	Valuation results discussed with Employers – final strategy elections made
1 April 2017	New strategies come into effect and Employers assigned accordingly
1 April 2017	Revised Contribution rates (set with regard to Employer's choice of strategy) come into force

Organisation Chart – Service Company



Risk Analysis

Risk	Unmitigated Risk			Mitigating Actions	Mitigated Risk		
	Likelihood	Impact	Overall		Likelihood	Impact	Overall
No buy-in from DCLG	Low	High	Medium	Ministers appear to be keen to explore the opportunity of better collaboration between LGPS Pension Funds	Low	High	Medium
Level of Investment Returns/ savings indicated not achieved	Low	Medium	Medium	The level of immediate savings is relatively modest. Longer term "savings" through better investment returns will need continuous monitoring and mitigating action taken if they are not forthcoming.	Low	Low	Low
Not being able to retain Administration staff to enable to business continuity	High	High	High	Operation of satellite offices to retain existing administration staff and transition to single office over time.	Low	Medium	Low
It takes a long time to generate the savings/ performance improvements.	Medium	Low	Low	A comprehensive project plan with clear and achievable objectives identifying where, how and when savings can be made.	Medium	Low	Low
Cost of implementation is greater than anticipated	High	High	High	Comprehensive project planning and budgeting.	Low	Low	Low
Enforced alternative merger by DCLG, because the proposed combined Fund would not be deemed optimum	Medium	High	High	On-going discussions with DCLG will allow the 3 authorities to influence the shape of any merged LGPS fund and get DCLG buy-in.	Low	Low	Low

Risk	Unmitigated Risk			Mitigating Actions	Mitigated Risk		
	Likelihood	**Impact**	**Overall**		**Likelihood**	**Impact**	**Overall**
Not all administering authorities agree to proceed with the recommended proposal	Low	High	Medium	Early consideration by all 3 administering authorities before undertaking more detailed work and holding discussions with DCLG will ensure that there is collective buy-in before proceeding any further.	Low	Low	Low