

Call for Evidence on the Future Structure of the LGPS

January 2014

*The LGPS Shadow
Scheme Advisory
Board analysis and
recommendations*

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Chair's foreword

The Shadow Scheme Advisory Board (SSAB) for the Local Government Pension Scheme (LGPS) in England and Wales is pleased to present its conclusions and recommendations for next steps following the Call for Evidence on the future structure of the Local Government Pension Scheme.

The SSAB views the Call for Evidence as an important step in the evolution of the LGPS in England and Wales.

It has become clear from the Call for Evidence exercise that there is a clear divide between those in favour of mergers and further consolidation and those who favour the status quo or a more modest move to scheme collaboration. It is also clear that there are a number of quite entrenched positions in this debate informed more by personal experience, than by data or research.

The Board is clear, however, that any structural reform to the Scheme – which will have far-reaching and long-lasting consequences – must be taken forward on the basis of solid evidence that the objectives for reform will be met and that benefits can be delivered to employers, local taxpayers and scheme members. Our recommendations include proposals for further work in this regard and how the objectives set out in the Call for Evidence can best be met.

The Board also believes that, as part of building that evidence base, it is essential that there is a clear, consistent and transparent set of data for the LGPS itself. The Minister has asked the SSAB to develop a single Scheme report. The Board is currently developing this report which will be issued in stages as various tranches of consistent and comparable data is collated. The SSAB will report on wider changes to LGPS data disclosure rules later this year.

The SSAB looks forward to working closely with the Minister and playing an active role in developing the outcomes to the Call for Evidence and any subsequent consultation exercise on structural reform to the LGPS in England and Wales.

Finally, I would like to thank members of the SSAB, and in particular the Call for Evidence Working Group that developed the response. Special thanks also goes to the Board Secretariat for their work and analysis.



Joanne Segars OBE

Chair of the Shadow Scheme Advisory Board

1. Executive Summary

The Board has an important role to play and, with representatives from across the LGPS, is uniquely placed to assist in the development of the LGPS and to advise the Minister on the direction and smooth implementation of reform. Our analysis of the evidence shows that the vast majority of responses accept the case that some reform is necessary but differ on the exact nature of reform. The most common reform options cited in responses were: greater use of passive mandates, collective investment vehicles (CIVs), and greater use of in-house management.

There was universal agreement that consistent and transparent baseline data needs to be achieved in order for the benefits of moving to any new structure or methodology to be accurately measured. Retaining local political accountability and the direct link between investment decisions and council tax payers was a key issue for fund respondents, as was the need for good governance.

The evidence appears to show indirect benefits of larger fund sizes, although any direct link between fund size and investment return in the LGPS is inconclusive. The majority of externally referenced responses make a case for funds moving to a greater degree of passive allocation or moving to a structure that would better enable an increased use of in-house investment.

However few responses set out ideas for managing deficits in a different way and therefore more work is required to develop feasible options to address this high level objective.

It is important to note that it has not been possible within the given timeframe to validate or independently verify the analysis presented in responses to the Call for Evidence.

The views and evidence in this report are a summary of the responses to the Call for Evidence and are not necessarily those of the SSAB.

At present, the SSAB has not had sight of the Department for Communities and Local Government's (DCLG) analysis, nor the report commissioned by DCLG and the Cabinet Office (CO) to analyse the practicality of certain reform options.

Recommendations

In light of the response to the Call for Evidence the Board makes the following recommendations:

1. The Government should consult on options for reform as soon as possible.
2. The Government and the Board should agree a realistic timescale for implementing reform by the end of Summer 2014.
3. The Board should complete the work on setting an agreed baseline of data and measurements via the Scheme Annual Report process by the end of 2014.
4. The Government should introduce proportionate and appropriate legislation to provide a statutory underpin for both the objectives of reform and the timetable for implementation.
5. In formulating its consultation on high level options for reform the Government should consider (a) alternative methods for managing deficits and (b) analyse the cost/benefits and barriers to greater passive management, Collective Investment Vehicles (CIVs) and in-house investment strategies.
6. The Board will support the Government by (a) developing a shortlist of feasible options for managing deficits and (b) conducting further research on the costs and benefits of the key options for reform.
7. That Government should ensure that any work being undertaken as part of the Call for Evidence is consistent with other strands of LGPS policy work, for example the LGPS 2014 governance regulations and any reform of the investment regulations.

The Board looks forward to playing a key role in taking forward these recommendations.

2. The Shadow Scheme Advisory Board's role in structural reform

The Shadow Scheme Advisory Board (SSAB) for the Local Government Pension Scheme (LGPS) in England and Wales was established in July 2013. It is the forerunner to the Local Government Pension Scheme Advisory Board, which is established under Section 7 of the Public Service Pensions Act 2013. The Shadow Board has been set up prior to the formalisation of the regulations setting out the formal remit of the Scheme Advisory Board, which are expected to come into force in late 2014 or early 2015.

The SSAB's primary functions are to:

1. Provide advice (on request or otherwise) to LGPS scheme managers and pension boards in relation to the effective management and administration of the LGPS and its connected schemes;
- And
2. Provide advice to the Secretary of State for Communities and Local Government on the desirability of changes to the LGPS.

It is in relation to this second function that the Minister of State, Brandon Lewis MP, asked the SSAB to provide advice on options for structural reform of the LGPS following the Call for Evidence, published by the Department for Communities and Local Government (DCLG) and the Local Government Association (LGA) in June 2013.¹

Members of the SSAB are drawn from LGPS employers, unions, officers and advisers. A full list of SSAB members and observers is set out in Annex A.

The SSAB looks forward to continuing to work with the Minister to play an active role in the future development of the LGPS in England and Wales to help deliver the outcomes identified through the Call for Evidence and subsequent analysis.

Box 1: Local Government Pension Scheme

- The LGPS has 1.7m active members from a total of 4.7m members and combined assets of over £150bn. As such, it is the fourth largest funded pension scheme in the world.
- The Scheme is administered by 89 funds in England and Wales. These range in size from £200m of assets under management (AUM) to £13bn, 2013.

¹ [Call for Evidence on the future structure of the LGPS, DCLG & LGA, June 2013.](#)

3. Call for Evidence

The Call for Evidence on the future structure of the LGPS was published jointly by DCLG and the LGA in June 2013² and a public consultation exercise ran until 27 September 2013.

The Call for Evidence was informed by the conclusions of the Independent Public Service Pensions Commission³, Chaired by Lord Hutton of Furness, and a roundtable hosted by the Local Government Minister Brandon Lewis MP in May 2013 which was attended by a wide range of stakeholders.

The Call for Evidence sought evidence from stakeholders on possible options for structural reform of the LGPS, including greater co-operation and structural change within the LGPS, with a view to driving greater cost and administrative efficiencies. In assessing the case for reform, the Call for Evidence set out eight objectives that any structural reform should seek to achieve. Two – dealing with deficits and improving investment returns – were deemed high level objectives:

High-level objectives

1. Dealing with deficits.
2. Improving investment returns.

Secondary objectives

1. To reduce investment fees.
2. To improve the flexibility of investment strategies.
3. To provide for greater investment in infrastructure.
4. To improve the cost effectiveness of administration.
5. To provide access to higher quality staffing resources.
6. To provide more in-house investment resource.

In considering and analysing responses to the Call for Evidence, the SSAB has given consideration to these objectives. In particular, the SSAB has considered responses in relation to the two high level objectives, including:

- whether these may be met through further structural reform of the Scheme; and
- whether, and if so what, further work and analysis might be required to ensure that any structural reform can deliver these high level objectives.

² [Call for Evidence on the future structure of the LGPS, DCLG & LGA, June 2013.](#)

³ [Independent Public Service Pensions Commission Final Report, March 2011.](#)

The SSAB's methodology

In arriving at its conclusions and recommendations the Board has been guided by the evidence provided in the 133 responses to the Call for Evidence. These responses are available on the SSAB's website.⁴

The SSAB has assessed the responses to the Call for Evidence and:

- identified the key themes and opinions expressed;
- determined which themes and opinions are supported by the evidence;
- identified the key issues and challenges to implementation identified in the responses; and
- determined the evidential basis of these issues and challenges.

In the time available, and with the resources currently at the SSAB's disposal, it has not been possible to analyse or independently verify the data or information included in the responses to the Call for Evidence.

On the basis of this analysis, the SSAB has developed its conclusions and recommendations for next steps which are set out in sections five and six of this document.

Since the Call for Evidence concluded, the Cabinet Office and DCLG issued a tender under the Open Policy Making process, through the Contestable Policy Fund⁵. Hymans Robertson LLP were commissioned to undertake analysis on the costs, benefits and technical issues involved in any potential restructuring and further collaboration of the LGPS and other public service funds. As part of this exercise Squires Sanders LLP were asked to consider any impediments to structural reform within the current statutory framework. The SSAB has not had sight of the conclusions of this work, and it has not therefore formed a part of the Board's conclusions and recommendations.

Box 2: Responses to the Call for Evidence

- 133 responses were received altogether.
- Over half were received from authorities with scheme manager responsibilities – 69 of the 89 funds in England and Wales submitted a response.
- 4 were submitted from trade unions and scheme members.
- 35 were submitted from the pensions industry (e.g. legal, investment and actuarial).
- 12 were submitted from representative bodies other than trade unions.

⁴ <http://www.lgpsboard.org/index.php/structure-reform/responses-public-view>. Please note that not all responses are available as some organisations wished their responses to remain confidential.

⁵ <https://www.gov.uk/contestable-policy-fund>.

4. Analysis

The base data

Two thirds of the 133 responses referred to existing studies of LGPS funds. The most commonly referred to studies were those of Hymans Robertson⁶ and State Street (WM Company),⁷ followed by PricewaterhouseCoopers' Reconfiguring the London LGPS funds⁸ and Welsh LGPS: Working Together (Interim Report).⁹

Around 25% of the responses presented analysis, statistics and/or information of their own. About a quarter of the responses appeared to be informed more by personal experience, than by data or research.

Where permission has been granted for publication, the responses have been uploaded to the Board website.¹⁰

The first stage of the Board's analysis was to list existing reports, papers and datasets commonly referred to in responses to the Call for Evidence. The second stage of analysis was to collate and summarise the views expressed and evidence provided.

In analysing the responses, the following principles were followed:

- views expressed have not been weighted either by quantity or origin. However, the number of responses that support a particular view have been reported where appropriate;
- evidence provided has been accepted as submitted, however, where such evidence conflicts this has been stated; and
- where evidence is not external to the respondent, this has been identified by the use of the word 'own'.

Overview of responses

Generally, the Call for Evidence has been accepted as a positive step for the LGPS. Nearly all of the responses agreed that there are gains to be made by collaboration, extending frameworks, collective investment etc. However, there is significant resistance to 'big bang' changes or forced mergers. In particular, the following views were expressed:

⁶ Hymans Robertson Investment management costs in the LGPS: global benchmarking study September 2013.

⁷ State Street Do Larger Funds Perform Better September 2013 and Lessons from internally managed funds March 2013.

⁸ PwC Reconfiguring the London LGPS funds October 2012.

⁹ Society of Welsh Treasurers - Welsh LGPS Funds working together March 2013.

¹⁰ <http://www.lgpsboard.org/index.php/structure-reform/responses-public-view>.

- That the same benefits can be gained by collaboration initiatives (while maintaining local control) without the implementation costs and disruption a full merging of funds would entail.
- Pensions are a long term investment – reform options should be carefully appraised and solutions tested against evidence and against a realistic timetable and with proper resource.

There were only a small number of responses which made no comment on options for reform. These included “*no case for reform has been made*”, or “*there is insufficient data to use as a start point for identifying cost savings*”.

Many responses suggested the range of options for reform were on spectrum, from the ‘status quo’ to full mergers of the existing LGPS funds. The views expressed on issues for implementation and transition were most prevalent at the ‘full merger’ end of the spectrum, but the general view was there would need to be a steady progression over time to any new structure rather than a ‘big bang’ approach, and that forced mergers would be met with significant opposition.

Data and assumptions

Many responses discussed the currently available datasets on the LGPS, the annual accounts and SF3 returns. 94 responses raised concerns over the lack of necessary data to guide decision making.

As a starting point, many recommended that a comparable set of data should be gathered as a basis for measuring the effect of any steps taken to reform the scheme. 14 responses recommended changes to assumptions/data collection methods in order to properly assess the options for reform. These responses came from a mixture of funds, industry and trade unions. Six of those reasoned that they were unable to properly engage in the debate about options without consistent comparable data. In their response, CIPFA suggested that DCLG consider devising a set of data disclosure standards to ensure that accurate fund-by-fund comparisons can be made.

There was a general consensus that there should be a data review, or data collection exercise to enable more transparency and comparability between funds. For example, Hymans Robertson noted¹¹ that the actual total (investment) costs at 63 basis points (bps) are greater than those disclosed under current accounting conventions at 32 bps (based on a sample of 12 LGPS funds).

In response to these concerns the Minister has tasked the SSAB with developing a single LGPS Annual Report to enable the consistent, comparable and accurate collection of

¹¹ Hymans Robertson, Investment management costs in the LGPS: global benchmarking study, September 2013.

information and data about the operation of the funds within the scheme. The SSAB is currently developing a single scheme report which will be issued in stages as tranches of consistent and comparable data is collected. The Board will report on wider changes to LGPS data disclosure rules later in 2014.

Current LGPS costs and performance

Costs charged to the funds for fund management and administration in England totalled £468m on total assets under management (AUM) of £148bn at end March 2012.¹² This means the average annual costs are 32 bps.

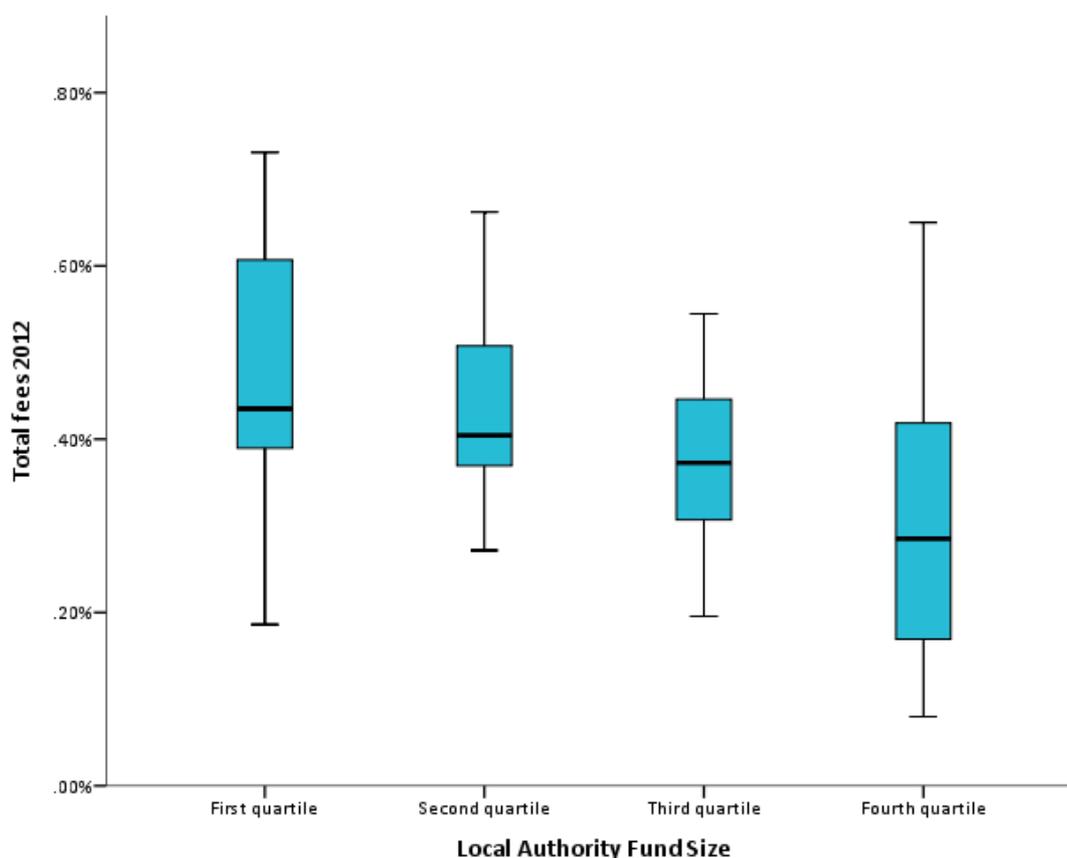
Based on the data provided, this average 'charge' is low when compared with the average annual management charge (AMC) of private sector schemes. The average AMC for DC schemes covered by the NAPF Annual Survey 2012 was 44bps.¹³ For private sector Defined Benefit schemes (DB schemes) it was 41bps.¹⁴ However, these costs drop considerably when figures are weighted by size of fund: the average LGPS funds' AMC drops to 23bps and for DB schemes to 25bps. This suggests that whilst the current costs of the LGPS are low compared with private sector pensions, the larger DB schemes and LGPS funds have lower costs and the differential between their costs is less. This is mainly due to the larger number of small DB schemes in the private sector that have higher per unit costs.

¹² Statistical release: LGPS Funds England 2011-12, DCLG, October 2012.

¹³ This is consistent with OFT's recent analysis of the workplace DC pensions market which found that the average AMC is 51 bps. Defined contribution workplace pensions market study, OFT, September 2013.

¹⁴ NAPF Annual Survey 2012.

Figure 1: LGPS fund range of costs (%) by size (AUM)



Source: NAPF LA fund annual report analysis 2009/10-2011/12, September 2013

The funds within the LGPS are relatively large compared with their private sector counterparts and range in size from £200m to £13bn at the end of March 2013. The average fund size was just under £2.0bn with the median fund somewhat lower at £1.2bn.¹⁵ The majority of LGPS fund costs in 2012, £353m, were spent on fund management fees¹⁶, with the larger funds in the LGPS having lower overall costs and investment costs.

However investment cost is only one part of the equation. PwC, State Street and several other parties have attempted to show whether fund size is correlated with investment performance and the results have been mixed. Analysis undertaken over a longer period, by APG, showed that from 2001-2009 funds realised an investment return of 1.7% per annum, 1% higher than the benchmark return for that period. This research also showed large differences in investment performance between funds and revealed that larger funds consistently achieved higher investment returns over this period.¹⁷ A Hymans Robertson report that analysed 10 year performance figures for the LGPS showed that larger funds outperformed by 0.6%, although mainly due to maximising economies of scale through more

¹⁵ State Street, Do Larger Funds Perform Better? September, 2013.

¹⁶ Statistical release: LGPS Funds England 2011-12, DCLG, October 2012.

¹⁷ Performance analysis of LGPS funds commissioned by Unison, Ruben Laros and Maurits Aben, APG Groep NV. The benchmark return was constructed from the relative size of the asset class multiplied by the corresponding benchmark for that asset class.

internal management and better diversification of assets.¹⁸ However, a PwC report on London fund performance showed that 18 out of the 28 funds under review had outperformed the biggest fund in the group.

However there are wider, more indirect factors such as including investment complexity, how investments are managed, in-house or externally, whether mandates are active or passive and the investment outlook, or long-termism that may have had an impact on fund performance. This is without taking account of risk adjusted returns.

High-level objective: dealing with deficits

Little evidence was provided by respondents to support any alternative methodologies for the better management of LGPS deficits, although one respondent did question whether the current accounting rules and valuation cycle is appropriate for an open scheme with a strong employer covenant. The argument was made that, in particular, mark-to-market accounting rules can generate wild swings in fund liabilities which can prompt knee-jerk responses and poor investment decisions.

High-level objective: improving investment returns

In responding to this second high-level objective we have grouped the analysis under the related secondary objectives.

Secondary objectives:

To reduce investment fees

Frameworks

One of the most popular options for reform was increased collaboration between funds. By collaboration, most went on to use frameworks as a specific example, but collaboration could also be viewed as sharing best practice and services in areas such as administration and governance.

There were 54 respondents, 35 of which were fund authorities, that mentioned increased collaboration as an option for meeting the objectives.

¹⁸ Welsh LGPS: Working Together (Interim Report), PwC, March 2013. The Hymans report was cited here. The period of performance under review and the proportion of the LGPS covered were not disclosed.

The use of frameworks was specifically mentioned by around 34 respondents, 25 of which were local authorities. Investment managers, consultants and professional bodies made up the remaining respondents.

The use of frameworks and collaboration is concerned with cost savings for procurement and shared services. Some anecdotal evidence was provided by the administering authorities themselves that collaborations have made cost savings. It was acknowledged in responses that cost savings are not easily verified and are often based on projections of cost savings, however, respondents felt there was clearly a benefit in management time savings which can be difficult to quantify. National LGPS Frameworks submitted their own response including evidence of benefits and savings as an appendix. There was also a range of other responses containing examples (this list is not exhaustive).

- The Value for Money and Collaboration Sub-Committee (set up by SSAB) survey of funds; examples of existing and planned collaborations.
- LGSS Pensions Service (Cambridgeshire and Northamptonshire Funds) (own statistic)¹⁹; has saved £500k p.a.
- London Councils (own statement): London Councils understands that there is a shared pensions administration service between Wandsworth, Camden and Merton that has already produced savings.
- Environment Agency (own statistic): The existing frameworks operating in the South West have already generated savings of over £1.5m.
- Tri-borough (London Borough of Hammersmith and Fulham, Royal Borough of Kensington and Chelsea, Westminster City Council) (own statistic): the individual boroughs have achieved reductions in fees from three common service providers ranging between 3 and 5 basis points.
- Wiltshire Pension Fund (own statistic): South West, savings from collaborative working; £400k in procurement savings across seven funds, further £150k in value-added services.

The scale and extent of existing collaborative work is encouraging. However, the savings identified above are relatively minor when compared to total investment costs.

¹⁹ Where evidence or statistics are referenced as 'own' they are based on the respondents data and/or analysis and have been repeated without verification.

To improve the flexibility of investment strategies

A number of the responses focused on funds delivering further investment efficiencies by changing the way they invest.

Collective Investment

Collective Investment Vehicles (CIVs) were the second most cited option for reforming the LGPS after frameworks. There were 32 respondents, 20 of which were fund authorities, which mentioned CIVs specifically as a means of meeting the objectives. The London CIV project is known across the LGPS and for clarity is a proposal concerned with a common investment vehicle or fund, not a common investment strategy. Individual funds would retain control of their asset allocations.

An Authorised Contractual Scheme, ACS is a new type of investment vehicle, mentioned in a few of the responses and is the preferred model being worked on by London Councils.

The general term 'pooling of assets' was used, and under this heading, the ideas ranged from pooling assets and having a collective investment strategy or mandate to funds with the same investment manager negotiating discounts based on the equivalent mandate were the assets pooled together.

Passive investment

A number of reports referenced the potential costs savings that could be achieved by greater use of low-cost passive investments and less use of 'funds of funds' structures in alternative assets.

For example, Hymans Robertson LLP produced the following assessment of performance using data published by all 101 LGPS funds, i.e. including Scotland.

	2006-07 %	2007-8 %	2008-9 %	2009-10 %	2010-11 %	2011-12 %	Annualised % pa
Median return	7.0	-3.1	-20.3	35.6	8.1	3.0	3.8
Index return	7.4	-0.7	-16.1	35.9	7.9	1.8	4.9

It concluded from this that *“the extent of index underperformance lends credence to a view that funds would benefit from a higher allocation to passive management than the current level of 24%.”*²⁰

In terms of structural reform, a move to greater use of passive management does not necessarily require combining funds as passive charges are relatively low. There is a concern

²⁰ Hymans Robertson LLP response to the Call for Evidence.

expressed by some respondents that very large passive mandates could only be delivered by a small number of investment managers, thereby reducing competition. However some of the smallest funds might still benefit from combining assets to secure greater buying power and there may be wider benefits to making changes to fund structures.

One key issue to consider is the potential impact on financial markets should all LGPS funds move to passive management where they are able to do so.

To provide for greater investment in infrastructure

The common response to this objective was that infrastructure investment should be considered as part of the investment strategy but it was not appropriate to have greater infrastructure investment as a secondary objective in the Call for Evidence.

Funds recognised that infrastructure could be a helpful asset class for long-term investors such as pension funds, but the 47 responses that raised the issue stated that investment in infrastructure was 'out of place' as a secondary objective, 35 of the responses that stated this view were fund authorities.

A number of respondents pointed out that the alternative way to seek greater returns would be through the use of in-house investment. This is explored under a later secondary objective: to provide more in-house investment resource.

To improve the cost effectiveness of administration

The evidence presented in the Call for Evidence responses suggested that there are wide variations in administration costs when comparing fund against fund. Some evidence was put forward suggesting potential cost savings could be achieved through improved efficiencies and operating at sufficient scale.

- North Yorkshire: Own²¹ analysis; *“We (NYPF) believe that 3 broad conclusions can be drawn – firstly funds achieve a level of efficiency once they reach approximately 30,000 members; secondly that the increased efficiency of much larger funds is relatively marginal thereafter; and thirdly that most funds with membership under 30,000 appear to have scope to significantly improve efficiency.”*

There were twelve responses, seven of which came from funds which suggest that there could be some merit in exploring scheme administration cost savings as an option for

²¹ Where evidence or statistics are referenced as 'own' they are based on the respondents data and/or analysis and have been repeated without verification.

reform. However, the savings described are marginal compared with potential savings on investment costs.

It is worth being aware that the new responsibilities on employers, from the LGPS 2014, have yet to be taken into account and the way administration costs are captured at present precludes the costs to employers participating in the scheme. There is little read across between administration costs and investment costs and it is therefore important that the particular requirements of administration are considered separately as part of the implementation of any new structure.

To provide access to higher quality staffing resources

A common option for reform recommended for meeting the objectives set out in the Call for Evidence was improving Scheme governance. Several responses cited appropriate investment strategies as more important than fees in improving overall investment return. Governance and higher quality staffing resources are intrinsically linked especially when considering the secondary objective of providing more in-house investment resource.

There were 29 responses that referred to governance as an important aspect of reform, nine specifically mentioned the need for appropriate investment strategies as crucial in meeting the reform objectives. In the context of the LGPS, some responses pointed to the benefits of a greater degree of separation between scheme manager and lead authority in managing potential conflicts of interest. This should be explored further and considered in any potential reform process.

In addition, the ability to take advantage of scale depends on good fund governance with better-governed funds better able to realise the benefits of economies of scale and secure improved investment returns through better decision making. For example, in its risk-analysis of DC trust-based pensions landscape, the Pensions Regulator argues that larger schemes are more likely to have higher standards of scheme governance. This is because they are better able to appoint high quality trustees, devote the time and focus needed to trusteeship and appoint the right professionals to advise trustee boards, supported by a dedicated pensions executive.²²

Local Accountability

Loss of local accountability was cited as an issue of concern on considering options for reform. There were 70 responses that raised the issue of loss of local accountability, 53 of which were fund authorities.

²² DC trust-based pension scheme features, TPR, January 2013.

Examples of typical fund authority responses in this area were:

"The direct link between LGPS Funds and an individual London Borough facilitates the highly important principles of clear democratic and local accountability, transparency and localism".

"The current governance arrangements within the LGPS where Pensions Committees are principally comprised of locally elected councillors already provide a high level of accountability to local tax payers and interested parties".

"Existing arrangements, whereby funds are administered by local authorities, provides accountability to local taxpayers. There is a danger that this could be lost or weakened were funds to be merged".

However another fund response stated that *"Whilst the importance of the locally elected Councillors on the current Pension Committees should not be under-estimated, we do not believe that a locally elected Committee should be a key issue in the debate, and indeed may potentially hinder the move to more efficient delivery models".*

Neither view was supported by any empirical evidence of the benefits (or otherwise) of local accountability.

To provide more in-house investment resource

There were ten responses referring to internal (in-house) management as an important option for reform. In particular 28 responses cited State Street analysis that concluded that internal (in-house) management, which is more cost effective for larger funds, leads to better investment performance outcomes.²³ A number of reports put forward evidence that internally managed funds consistently outperform externally managed funds across all asset classes over the long term. State Street said that "over the 25 years ending 2011, the internally managed group has outperformed the WM All Funds Universe in 17 years. Over the entire period, after fees, internally managed funds in aggregate delivered a return of 8.8% p.a. compared to a return of 8.3% p.a. from the Universe."²⁴

Whilst operating within a different legal and political context, the Canadian public sector public sector pension funds were used as a peer comparison in six responses to the Call for Evidence. Evidence from Dyck and Pomorski *Is Bigger Better? Size and Performance in Pension Plan Management*²⁵ and The Boston Consulting Group (BCG), Canada *The Top Ten*

²³ State Street, *Do Larger Funds Perform Better?* September 2013.

²⁴ State Street, *Lessons from Internally Managed (IM) Funds*, March 2013.

²⁵ Dyck and Pomorski *"Is Bigger Better? Size and Performance in Pension Plan Management"*, July 2011.

Investing for Canada on the world Stage²⁶ further supports the case that cost savings and efficiencies can be delivered through greater use of in-house management.

Some respondents noted that the context of local authority salary structures could be a challenge in moving to an in-house management structure. State Street have looked more closely at the performance, costs and salary constraint of the Canadian model²⁷. They state that in Canada *“there has been a marked move towards increased level of internal management within their public sector pension funds. Performance of these funds has improved as a result. These funds believe that one of the factors facilitating the improved performance is the ability to attract and retain top investment professionals. This has been done by setting them up as quasi-independent entities that allow the decoupling of salaries of these professionals from existing public sector pay scales. While this has pushed up the cost of internal management, it remains well below that paid by external funds while, at the same time seeing an improvement in net performance”*.

It was highlighted that in-house management is better achieved by larger funds who are better able to absorb higher staffing costs and achieve the required governance standards. Therefore three of the responses (two London authorities and the London Pensions Fund Authority), put forward the idea of 'Super Pools' as an alternative to both CIVs and full merger. In the Super Pool funds could be aggregated, but unlike a CIV asset allocation would be decided centrally, better enabling funds to make greater use of in-house management.

It is important that 'more in-house investment resource' is considered separately from 'passive investment' above and in this context, is not solely interpreted as running passive asset portfolios internally. There is a spectrum of in-house management. At one end it is much more about in-house professionals managing and monitoring all the portfolios of external managers (active or passive) and the strategic position across a full range of asset classes supporting the strategy and liability profile of their specific fund(s). At the other end it involves the direct management of assets. There will be differing costs, efficiencies and investment returns depending on which end of the spectrum fund management operates.

Mergers

There were 18 responses that included mergers in their considerations for options for reform, five of which were fund authorities. The remaining 13 responses were from the private sector and others (trade unions, individuals and think tanks).

Most of the positive views on merging funds (assets and liabilities under central control) came from the private sector and focused on the smallest of the LGPS funds merging together. The exception was the proposal for the merging of three funds in the southeast

²⁶ The Boston Consulting Group (BCG), Canada The Top Ten Investing for Canada on the world Stage, June 2013.

²⁷ State Street, Lessons from Internally Managed (IM) Funds, March 2013.

which came from the authorities themselves. Many funds were of the view that the same benefits could be gained by collaboration, extending frameworks and collective investment, without the implementation costs and disruption a full merging of funds would entail.

The authorities that did not rule out merging funds tended to imply that merging should be a voluntary option, that flexibility is an important factor or suggested that the Secretary of State take reserve powers to force mergers where funds have been shown to deliver poor performance, governance and fund management.

Investment Capacity Constraints

There were 23 responses (a mixture of all types of respondents) that raised the issue of constrained capacity if funds were merged and the consequential impact on investment strategy and opportunities. In particular whether there was constrained capacity around particular active investment mandates and limited investment opportunity for large sums.

For example one response from a fund stated that *"on the other hand, very large LGPS funds could be too large for the best investment managers who may not have the capacity to take on very large portfolios. For some asset classes, the best investment management might be available from 'boutique' or mid-sized managers"*.

An industry response stated that *"if fewer bodies are involved in decision making with bigger pots of money being allocated, care would need to be taken to manage capacity appropriately. A single or smaller number of bigger LGPS entities could exclude itself from investing in a number of asset classes or products through the problem of not being able to deploy capital adequately."*

Transition Costs

There were 66 responses which raised concerns about the potential costs of transition to a smaller number of funds, 42 of which were from local authorities. Whilst transitional costs would be incurred under any of the options for reform, the cost of merging funds was cited as a particular issue for consideration. It was pointed out that the opportunity cost of not undertaking reforms should also be considered in evaluating the possible reforms.

Since the Call for Evidence, DCLG and the Cabinet Office have made some steps to assess the cost of three options via a contestable policy fund process. The outcome of the exercise, essentially a cost/benefit analysis, may go some way to meet those concerns.

The timescale for reforms, and regulatory issues to consider were raised in many responses. The above cost benefit analysis exercise may also address these points.

Legal barriers to reform

Although not raised explicitly as an issue, the potential for legal challenges when seeking reform should not be underestimated. The contestable policy fund process referred to above is considering such barriers. LGPS administering authorities are creatures of statute with their governance, funding, investment and scheme rules set by legislation, any changes will therefore have to be considered in the light of the legislative changes required to successfully bring them about. The point was made a number of times that should legislation and a change in structure be required, it could be a golden opportunity to address some of the structural and governance problems inherent in the current structure.

5. Conclusions

In reaching the conclusions below the Board has attempted to balance the number of responses in a particular area to the evidence provided. It has not, for example, made the assumption that the popularity of an opinion lends it any evidential weight. Also the Board has sought to balance the evidence based on the scope and extent of the data on which it is based.

Based on the analysis of the responses and the evidence provided the following conclusions can be reached:

1. The vast majority of responses accept the case that some reform is necessary but differ on the exact nature of reform. The most common reform options cited in responses were: greater use of passive mandates, CIVs, and moving to a structure that allows for greater use of in-house management.
2. An agreed, consistent and transparent baseline of data needs to be achieved in order for the benefits of moving to any new structure or methodology to be accurately measured.
3. Few responses set out ideas for managing deficits in a different way and therefore more work is required to develop feasible options to address this high level objective.
4. A large number of fund respondents referenced the importance of retaining local political accountability and the direct link between investment decisions and council tax payers. However little, if any, empirical evidence was provided on the benefits, or practical application of, such accountability or the link having any effect on voting patterns.
5. A number of respondents referenced the need for good governance in securing successful reform and further efficiencies. In the context of the LGPS, some reports point to the benefits of a greater degree of separation between scheme manager and lead authority in managing potential conflicts of interest.
6. There appear to be indirect benefits to larger fund sizes including direct access to asset classes thereby avoiding the use of costly fund of fund vehicles, greater use of in-house investment, the potential for more robust governance structures and lower per member management costs. However the evidence about whether fund size is correlated with investment performance and the results have been mixed.

7. The majority of externally referenced responses make a case for funds moving to a greater degree of passive allocation or moving to a structure that would better enable an increased use of in-house investment. The evidence points to either of these providing a better mix of return and cost but each would require different structures/legislation to implement – more work is needed here to assess the cost/benefits/barriers of each model, if this is not apparent from the contestable policy work.
8. The argument that larger administration services lead to lower costs is put forward in a number of responses. However the level of administrative costs currently stated is relatively low. That said the new responsibilities on employers from the LGPS 2014 have yet to be taken into account and the way administration costs are captured at present precludes the costs to employers participating in the scheme. There is little read across between administration costs and investment costs and it is therefore important that the particular requirements of administration are considered separately as part of the implementation of any new structure.
9. Whatever option is taken forward, some form of legislation will be needed whether this is to embed the reforms, amend the investment regulations or provide for new structures. Therefore careful consideration should be given to the availability of parliamentary time.

6. Recommendations

From the above conclusions the Board has made the following recommendations:

1. The Government should consult on options for reform as soon as possible.

The Board recognises that the Government is keen to consult on this issue and will continue to undertake its own analysis and consultation with LGPS stakeholders to inform this consultation process as well as providing its own response.

2. The Government and the Board should agree a realistic timescale for implementing reform by the end Summer 2014.

One of the key concerns of respondents was that any transition needs to be managed carefully to avoid undue costs and to ensure that any new structure is delivered successfully. Therefore the Board believes that a realistic and clear timetable for implementation is paramount.

3. The Board should complete the work on setting an agreed baseline of data and measurements via the Scheme Annual Report process by the end of 2014.

In response to these concerns the Minister has tasked the SSAB with developing a LGPS Annual Report to enable the consistent and accurate collection of information about the operation of the funds within the scheme.

The SSAB is currently developing a single scheme report which will be issued in stages as various tranches of consistent and comparable data is collected. The Board will report on wider changes to LGPS data disclosure rules later in 2014.

4. The Government should introduce proportionate and appropriate legislation to provide a statutory underpin for both the objectives of reform and the timetable for implementation.

Whatever option is taken forward some form of legislation will be needed whether this is to embed the reforms, amend the investment regulations or provide for new structures. Therefore careful consideration should be given to the availability of parliamentary time. In particular Government should explore the benefits of a greater degree of separation between scheme manager and lead authority in managing potential conflicts of interest as part of any reform process.

- 5. In formulating its consultation on high level options for reform the Government should consider (a) alternative methods for managing deficits and (b) analyse the cost/benefits and barriers to greater passive management, CIVs and in-house investment strategies.**

Further analysis is also required on the detailed costs and benefits of the key reform options to assess which best delivers against the high level objectives the Government has set. The Board is looking forward to working closely with the Government on the detail of these options and analysis.

- 6. The Board will support the Government by (a) developing a shortlist of feasible options for managing deficits and (b) conducting further research on the costs and benefits of the key options for reform.**

Few responses set out ideas for managing deficits in a different way and therefore more work is required to develop feasible options to address this high level objective.

- 7. That Government should ensure that any work being undertaken as part of the Call for Evidence is consistent with other strands of LGPS policy work, for example the LGPS 2014 governance regulations and any reform of the investment regulations.**

There is considerable change currently underway within the LGPS and we need to ensure that the various strands of policy work do not compete or contradict one another. The Board looks forward to playing a key role in taking forward these recommendations.

Annex A: Shadow Scheme Advisory Board members and observers

Chair: Joanne Segars OBE

Scheme Employers:

Cllr Roger Phillips (Con) – Vice-Chair
Cllr Kieran Quinn (Lab)
Cllr Ian Bond (Lib Dem)
Cllr Denise Le Gal (Con)
Cllr Mary Barnett (Welsh fund authorities)
Education employers tbc

Scheme members

Jon Richards (UNISON)
Chris Tansley (UNISON)
Brian Strutton (GMB)
Gary Warrick (GMB)
Fiona Farmer (Unite)
Dave Mathieson (Unite)

Scheme advisors

Peter Summers (Fund Actuaries)
Chris Bilisland (Fund Treasurers)
Nicola Mark (Fund Practitioners)
Gary Delderfield (Legal advisor)
Bob Summers (Public Finance and Accountancy)

Scheme observers

Chris Megainey (DCLG)
Bob Holloway (DCLG)
Bob Scruton (The Pensions Regulator)
Helen Forrest (NAPF)