

8 February 2016

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LGPS Reform  
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Dear Victoria

**Local Government Pension Scheme: Investment Reform and Guidance  
– November 2015**

Although this guidance is not a consultation paper, in view of the strategic importance of the proposed reforms for the future structure and performance of the LGPS, CIPFA feels it may be helpful to outline:

- (a) CIPFA's support for the overall direction of the reforms
- (b) Importance of project planning and timescales recognising the scale of the change, risks and funding of initial costs
- (c) Areas where more clarification / additional work would be helpful.

CIPFA is extremely aware of the cost pressures facing local government following the latest CSR. Increasing demand for statutory services and an aging population are set against severe reductions in funding from previous financial settlements and the additional pressure from the latest CSR. The LGPS has around 11,000 different employers. Most of these will be affected by reduced government funding for local authorities.

LGPS employer costs of £6.9bn for England in 2014 – 2015, are a material item of inescapable cost for all local authority budgets. The cost has to be funded and adds to the complexity of painful decisions which now have to be made about service priorities affecting local communities and the services they value and need. At an individual employer level, dependant on the local funding position and recovery of past deficits, employer costs can represent 20-30% of pensionable pay or even more, a very significant cost.

With this background CIPFA welcomes and fully supports innovative thinking on the overall affordability, efficiency and sustainability of the LGPS. In response to the May 2014 consultation "Opportunities for collaboration, cost savings and efficiencies" CIPFA welcomed the opportunity for reduced costs and enhancement of investment options and performance prospects facilitated by a small number of asset pools. Forecasts provided by the London CIV and the Lancashire / LPFA and most recently the authorities who worked with Hymans Robertson in "Project Pool" are illustrating the potential benefits. CIPFA fully endorses the benefits of asset pooling when seen against the cost pressures facing local authorities and employers.

In previous comments CIPFA has also mentioned the considerable work being undertaken by practitioner-led initiatives to achieve greater collaboration and partnership working. The national partnership framework has achieved savings of £16m. CIPFA endorses the importance of continuing to support this work. The possibility of collaborated vehicles for LGPS investments should continue to be considered.

Moving from the current LGPS structure to a small number of asset pools will be a project of considerable size and complexity. Further clarification of legal issues is essential and achieving a governance structure which, as the guidance requires, enables local demographic accountability whilst maintaining accountability of a separate asset pool will be a considerable challenge.

CIPFA note that Hymans Robertson observe that delivering the changes is an enormous undertaking and a transition of assets on the scale required has never been achieved previously. CIPFA is extremely aware of current and projected pressures on LGPS administrative resources, moving to asset pools will add considerably to the workload. The risks when set against required timescales are significant and need to be fully identified by all LGPS funds in initial project planning and outlined in responses to the guidance. Risk management must ensure that all relevant risks are identified. They need to be considered in detailed planning and timescales for setting up the asset pools. Funds will need to ensure that they keep all their employers conversant with the issues involved in setting up the asset pools and the risks.

The Hymans Robertson study shows that costs will outweigh savings in the early years of the asset pools. CIPFA is also aware of the work undertaken by the London CIV and the Lancashire/ LPFA work. Financing these costs could have implications for forthcoming fund valuations. Initial costs must be identified and the implications for employer contribution rates, particularly those where a long term view cannot be taken, must be understood. LGPS funds need to identify these issues when responding the guidance.

All the evidence does point to the long term benefits of asset pools. CIPFA fully endorses the importance of securing these benefits.

Looking at the key issues identified in the guidance there are other overall points which CIPFA feels need further explanation and additional consideration.

In making the comments below CIPFA wishes to emphasis its commitment to innovative reform and would be pleased to work with the government on all these aspects.

### **Number of Asset Pools**

The guidance mentions that 6 wealth funds are to be created with limited in house management outside the pools. Funds are to suggest how their pooling arrangements are to be constituted and operate having regard to four stated criteria.

Earlier work by Hymans Robertson in the December 2013 "LGPS Structure Analysis" outlined the benefits of 5 -10 asset pools. Around the country CIPFA is aware that 8 asset pools including a possible pool for the Welsh funds are being examined. Accepting the principle of a small number of asset pools CIPFA would ask for more flexibility around the exact number of asset pools including £25bn rule, the actual number to be determined when initial proposals are examined after the February submissions. The price base for the £25bn rule needs to be clarified, especially when set against recent stock market volatility.

Likewise the possibility of in house management continuing, if justified against an alternative of a pooled approach, is to be considered after the February submissions. Evidence from, for example CEM, points to the benefits of internal management. The

guidance mentions that a minimal amount of investment may take place outside the pool. CIPFA would ask that a flexible approach is applied dependant on the supporting rationale and flexibility to invest outside of asset pools should be recognized. The recent work by Hymans Robertson illustrates the complexity involved when creating asset pools and the importance of a flexible approach.

The guidance and the previous announcement by the government advises that asset pools are to be wealth funds. CIPFA is not sure whether this has any additional implications beyond those already outlined as this terminology is usually used for state owned investment funds. Ownership of the underlying assets in the asset pools would, dependant on the exact structure, reside with the pool or continue as local owned investments. It would be helpful if the terminology "wealth funds" could be clarified.

### **Choice of Asset Pool**

Asset pools will be managing public funds and need to demonstrate accountability and transparency. The guidance outlines the criteria funds should apply when determining their pooling arrangements. Applying the criteria could still though leave open a choice of different pools. CIPFA would ask that funds are accountable for and can demonstrate why a particular asset pool is preferred and that this requirement is included in subsequent guidance. This is especially relevant as the approach to pooling is not necessarily following any particular regional bias.

### **Structure of Asset Pools**

Multi asset pools allowing for investment in arrange of assets could achieve the requirements of the guidance. Work already undertaken by authorities has established that an asset pool could either be an ACS structure similar to the London CIV or it could have a joint committee approach. CIPFA acknowledges the helpful advice provided by PWC in the detailed technical analysis. The recent Hymans Robertson study "Project Pool" identifies the complexity of legal issues. CIPFA is aware that material issues include in a joint committee approach issues around FCA authorisation, the use of life policies, and vehicles needed for illiquid assets. The timescales identified in the guidance are pressing, legal issues require resolving as soon as possible. CIPFA would ask that work with authorities is undertaken on these issues to enable if possible, resolution before detailed proposals are submitted in July.

### **Investment Performance**

Investment performance for the LGPS is fundamental with the link to actuarially determined employer contribution rates. The LGPS has benefited from strong investment performance. Funds can have significantly better performance and this raises another issue. For employers in this category there could be an unwelcome cost if movement to an asset pool results in reduced investment prospects and consequential pressure on employer contribution rates. A fund could be achieving strong returns from a particular manager at a time when a movement to a pool is required. For some employers, particularly the smaller bodies within the LGPS even more pressure on contribution rates could be very damaging. CIPFA would ask that this is examined in subsequent work on creating the asset pools. CIPFA has already commented on how investment performance could be offset by initial costs, which might have implications for employer contribution rates. Planning for the implementation of asset pools and the timing needs to ensure that these issues are fully identified and discussed with all employers and fund actuaries.

CIPFA is pleased to see that the consultation paper Local Government Pension Scheme: Revoking and replacing the Local Government Pension Scheme ( Management and Investment of Funds ) Regulations 2009 outlines a proposal to remove the requirement for the performance of investment managers to be reviewed every 3 months. CIPFA fully endorses the recommendations from Professor John Kay's review of UK equity markets and long term decision making.

## **Timescale**

Securing asset pool benefits and favourably impacting on employer contribution rates at the earliest practicable opportunity is essential, but this needs to be set against a full understanding of risks as the guidance outlines. An early risk is the potential for abortive work and delays if a pooling proposal is unacceptable. It would be preferable if advice were available after the February submissions if this is a concern, to avoid the possibility of further unnecessary work and cost. This is especially relevant with the complex nature of pooling structures and governance arrangements necessitating costly advice and the reality that at the moment the number of potential asset pools is greater than the 6 required by the guidance.

Work required after the July submission will be considerable and will need to take place against all the complexity of continuing management of the LGPS including the 2016 valuation, management of local pension boards and administration of benefits for around 11000 different employers. Funds are already under great pressure from reduced staffing levels. Pooling work is adding considerably to the workload. It is for authorities to determine how best to manage, identify risks and mitigate those risks where possible. CIPFA would ask that the government keep in mind the considerable pressures at a fund level where resources are very limited when considering the next stages for pooling.

## **Governance**

The guidance rightly emphasises the importance of strong governance and decision making along with democratic accountability. CIPFA strongly supports transparent, accountable decision making and fully endorses the importance attributed to this in the guidance. When commenting previously CIPFA suggested that the governance structure of collective investment vehicles should be built around the following principles:

- (a) Flexible – the governance model should be structured in such a way as to allow full participation in key decision making. A closed model that excludes investors from, for example, manager selection, may affect investor buy-in to collective arrangements.
- (b) Skilled – participants in the governance structure should possess the appropriate knowledge and skills to undertake the role. CIPFA has a Knowledge and Skills Framework for Elected Representatives and Non-Executives and a Code of Practice. This was enhanced in 2015 by a publication on the Role and Responsibilities of the Chief Finance Officer. A Knowledge and Skills framework for Local Pension Board members was also published in 2015.
- (c) Transparent- the activities of the governance body should be open and transparent to all LGPS stakeholders, with records of meetings etc. made publically available. Transparency should also extend to the ability of stakeholders of individual funds to “look –through” the vehicle to the investments in which their fund is invested.

The proposed approach to local asset allocation does strike the right balance between local accountability and benefits provided by an asset pool.

There is a clear chain of accountability between the administering authority and the elected members that make up those charged with the governance and decision making in an LGPS fund on the one hand , and the local electorate ( from whence the majority of LGPS participating employers draw their funding ) on the other. The public availability of committee minutes and the requirement to publish an annual report on pension fund activity including the role of the local pension board enables stakeholders to scrutinise the activities of decision makers and hold them to account for those actions. CIPFA welcomes the acknowledgement of this important democratic link.

CIPFA has previously published best practice guides and codes on governance, a key part of CIPFA's role. In view of the importance of this area CIPFA would be pleased to undertake further work and develop best practice looking at governance in the context of funds and asset pools.

### **Infrastructure**

This is an important asset class within a diversified authority investment portfolio with features which can provide much synergy with LGPS requirements. Inclusion within a particular portfolio is a local decision having regard to the authority's investment strategy, liquidity and approach to risk and volatility. Asset pools with increased funds and resources for due diligence work will open up opportunities. But, additional investment in the asset class will only be made if it meets fund requirements including performance and legal obligations. It is pleasing to see that the government accepts this fundamental principle. CIPFA fully endorses this principle with the LGPS needing to comply with local accountability and legal requirements. The most appropriate vehicle for infra-structure investment including the possibility of establishing a national platform requires examination.

### **Accounting / Disclosures**

Considerable work has already been undertaken to improve fund transparency on the reporting of investment and management costs. CIPFA published in 2014 "Accounting for Local Government Scheme Management Costs" for application to accounts from 2014 - 2015. This has recently been reviewed and an update to the guidance will be published shortly. Creation of asset pools, dependant on the actual structure, might involve compliance with corporate and local authority accounting requirements. Irrespective of the accounting and disclosure framework there will be a need to demonstrate transparency and consistency of approach for pool comparisons and subsequent analysis. This raises an issue of compliance and the status of advice. The current advice has good practice status, compliance being a matter of local judgement - although CIPFA has urged funds to adopt the advice. It is clear from analysing 2014- 2015 accounts that it was not universally applied. Consideration is being given to elevating the status of the guidance for 2015- 2016 and whether there should be mention in Accounts and Audit regulations. CIPFA will continue to work on fund accounting and disclosures to improve fund accountability and transparency and provide data for pool cost and performance comparisons.

### **Scheme Board Role**

Creating asset pools is a considerable challenge for the LGPS. There is already extensive networking between practitioners and other stakeholders and sharing of knowledge from the experience of the London CIV and the Lancashire / LPFA work. This is a fundamental strength of the LGPS and the role of the national Scheme Board is a key component. The Boards work on deficit management and key performance indicators is providing essential tools to funds as they seek greater efficiency and performance. Comparative data on asset pool performance and costs will now be needed. This reinforces the importance of the Scheme Board role and CIPFA will be pleased to work with the Board in developing appropriate tools to assist the asset pools.

## **Passive Investment**

CIPFA welcomes the approach to passive management outlined in the guidance following extensive discussion with stakeholders after the publication of the May 2014 consultation *Local Government Pension Scheme: Opportunities for Collaboration, Cost Savings and Efficiencies*.

CIPFA considers that passive management does form an important part of an LGPS investment strategy and the value for money benefits should be considered alongside other investment options. The requirement in the guidance for funds/pools to be able to demonstrate the benefits of active management is welcomed. Continuing to improve data on inter-fund comparisons to provide the toolkit for the evaluation of costs and benefits is essential. CIPFA undertook considerable work on the accounting and disclosure of investment management costs and published *Accounting for Local Government Scheme Management Costs*. This work has recently been reviewed and further guidance will be published in 2016. CIPFA will be pleased to work with the Scheme Advisory Board on the continuing development of this advice.

## **Power of Intervention**

The proposals outlined in the consultation paper *Revoking and replacing the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009* raise a difficult issue around local accountability. CIPFA acknowledges the steps outlined in the consultation before intervention powers are invoked. However, CIPFA is concerned about the possibility of such powers being required. If these powers are applied they will completely detract from local accountability, a fundamental strength of the LGPS. CIPFA accepts that this power is to be used as last resort, but would ask that consideration is given to a further step before applying these powers. An advisory team could be created to supply help on a supportive basis where required to funds in difficulty and provide an opportunity for self-improvement before powers of intervention are used. This has been discussed informally at the Scheme Board. CIPFA would ask that this is now examined and would be pleased to discuss how this can be achieved. CIPFA's concerns on the proposed power of intervention are outlined in our response to the consultation *Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009*.

I hope these comments are helpful. If you would like to discuss further any of the points raised, please do not hesitate to contact me or Neil Sellstrom ([neil.sellstrom@cipfa.org](mailto:neil.sellstrom@cipfa.org)).

Yours sincerely



**Rob Whiteman**  
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