CIPFA Pensions Network
CFO Briefing – LGPS Reform

An affordable, sustainable future for the LGPS

- Linda Selman

- 3 June 2014

- William Marshall

- 9 June 2014

Agenda

- Developments to date
- Hymans Robertson's research for DCLG (Dec 2013)
- Consultation on CIVs and use of passive (May 2014)
- Next steps
- Hymans Robertson's beliefs
- Appendices – detailed findings from research for DCLG

DEVELOPMENTS TO DATE

A year is a long time……

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May 2013 | **June – Sept 2013** | **Nov – Dec 2013**

- **Brandon Lewis at NAPF** → Fund merger seemed likely?
- **FTfM article** → Criticism of LGPS invest. costs but bad data
- **DCLG / LGA call for evidence** → Consultation objectives:
  1) managing deficits; &
  2) investment efficiency
- **Hymans/CEM investment cost benchmarking** → First good data on investment costs + international comparisons
- **Hymans Research for DCLG** → Cost-benefit analysis for 3 options including asset pooling

….in the LGPS

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Jan 2014

SAB analysis of CfE responses & letter to minister

Themes:
-use of asset pooling?
-use of passive?
-use of in-house?
Consider options for managing deficits

Feb 2014

London Councils give London CIV green light

Collective Investment Vehicle for London Boroughs. Voluntary participation

May/July 2014

Next DCLG consultation

Merger ruled out
Instead consulting on asset pooling and greater use of passive

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Themes that emerged from the Call for Evidence

- Asset pooling as an alternative to fund merger
- Reduce use of Funds of Funds for alternatives
- Greater use of passive for listed
- Governance critical

Overall aim: helping ensure the long term affordability and sustainability of the LGPS

REPORT FOR DCLG – DEC 2013

Research commissioned by Ministers - scope

- Quantify **investment costs** including turnover costs
- Identify potential **cost savings**
- Costs and benefits of **active and passive** strategies
- Since cannot look at costs in isolation, assess net of fees **performance** against market indices for LGPS in **aggregate**
- Estimate **cost of change** to new operational structures that might be used to deliver cost savings (collective investment vehicles or merged funds)
- **Practical and legal impediments** to implementation and the realisation of benefits

Research to inform next phase of consultation

Research commissioned by Ministers - scope

- Using this data, assess potential to deliver benefits under three options
  - Keep 89 Funds but single asset pool
  - Keep 89 Funds but 5-10 asset pools
  - 5-10 Funds
- Cost benefit analysis
- Sensitivities e.g. uptake, transition costs

Objective, evidence based analysis

Out of scope

- A recommendation on which option should be taken forward
- Dealing with deficits
- Member administration
- Quantification of any governance dividend
- Focus on “hard” costs, not “soft” outcomes

We were not asked to make any recommendation e.g. on the amount that should be invested passively or the most appropriate way forward

Partner organisations

- **Hymans Robertson** LLP:
  actuaries, investment consultants, pensions change management
- **CEM Benchmarking** Inc:
  a global firm specialising in the benchmarking of investment performance and costs
- **Squire Sanders** (UK) LLP:
  a global law firm with a leading public sector pensions practice

Research to inform next phase of consultation

Summary of findings

Question in brief	Finding
LGPS Investment costs	c£790m per annum
LGPS fees vs international peers	LGPS lower on some asset classes
Areas for savings	Implementation style (FoFs, passive)
Est savings from no longer using FoF on alternatives	£240m per annum after 10 years (13bps of assets)
Savings if all listed investments passive	£230m per annum (12bps of assets)
Transition cost	£215m (£47m stamp duty)
Impact on aggregate LGPS performance for listed	Over last 10 years no impact on performance
Merger vs asset pooling	Merger delays emergence of savings and lost local decision making

Conditions for delivery of benefits

- Legislative changes required
- Large asset pools to maximise scale benefits
- Careful management of any transition to minimise costs (explicit and implicit)
- Allow existing fund of funds investments to run off
- Widespread participation: estimated cost savings are based on full participation

CONSULTATION ON CIVS AND USE OF PASSIVE (MAY-JULY)

Proposals for consultation

- Merger no longer the government's preferred option
- Instead consulting on:
  - use of asset pooling (collective investment vehicles) for investment scale benefits
  - CIVs for alternatives and listed investments
  - greater use of passive for listed
  - governance aspects

Consultation Qs

- Q1. Do you agree that CIVs would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Explain and evidence your view.
- Q2. Do you agree with proposal to keep decisions about asset allocation with local fund authorities?
- Q3. How many CIVs should be established and which asset classes should be separately represented in each of the listed and alternative asset CIVs?

Consultation Qs

- Q4. What type of CIV do you believe would offer the most beneficial structure? What governance arrangements should be established?
- Q5. In light of evidence on relative costs and benefits of active passive investment and aggregate LGPS performance data, which option for passive investment offers best value for tax-payers:
  - 1) Compulsion (all listed securities to be passive)
  - 2) Specified %age passive or progressive increase
  - 3) “comply or explain”
  - 4) Funds simply be expected to consider the benefits

NEXT STEPS

Next steps

- Consultation closes 11 July 2014
- Date for government decision and action unknown – another consultation?
- Other related developments:
  - London CIV progressing – live 2015?
  - Closer look at ways of managing deficits (SAB)
  - Changes to investment regulations
  - Changes to local governance arrangements

HYMANS ROBERTSON'S BELIEFS

The future of the LGPS – our beliefs

- CIVs have the potential to achieve benefits of scale and good governance
- There is scope to increase the use of passive management
  - Some characteristics of active management can be replicated ‘passively’/systematically at lower cost
- Active management has a role
  - For more complex and less liquid asset classes
  - For listed assets in sectors or regions where there is evidence of an ability to consistently add value

The future of the LGPS – our beliefs

- ‘Comply or explain’ is the best option
  - Opportunity to retain the stronger elements of performance
- Good governance is the key
  - At local level – strategy decisions
  - At CIV level

The bigger picture

- Deficits pose a significant challenge
- No magic solution
  - More contributions, cost control, good investment performance are all required
- Tackling accessible cost savings is worthwhile and will chip away at the deficits

APPENDICES

“LGPS Structure Analysis”

Hymans Robertson, December 2013

Detailed findings

COSTS

Database for fee information

Fund size	All LGPS	Funds included
£5bn +	29.9%	23.6%
£2-5bn	35.1%	46.2%
£1-2bn	20.9%	19.4%
Less than £1bn	14.0%	10.7%
Total	100%	100%
Total Assets	**£180bn**	**£38bn**
Number of funds	**89**	**18**

Data provided by 18 LGPS funds of varying size

A good representation of aggregate LGPS

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Total fees by asset class and active/passive

Asset class	% of total assets	Active fees (£000)	Passive fees (£000)	Total (£000)	% of total fees
Equities	65.8	256,963	31,103	288,068	**38.5**
Bonds and cash	17.6	54,535	7,141	61,674	**8.2**
Property	6.8	97,996	0	97,996	**13.1**
Alternatives	9.8	300,883	268	301,151	**40.2**
Total	**100.0**	**710,377**	**38,512**	**748,890**	**100.0**

Source: CEM Benchmarking Inc., data provided by 18 LGPS funds

Fees analysed by asset class and style of investment

Total LGPS fund value and fee budget split by asset class

Passive management is cheap
Alternatives are expensive

Impact of increasing passive for quoted assets

	Fees (£000)	% of total fees
Equities (all passive)	95,217	18.4
Bonds (all passive)	23,089	4.5
Property (all active)	97,996	18.9
Alternatives (predominantly active)	301,151	58.2
Total with listed assets passive	**517,453**	**100.0**
Total with active management	**748,890**	

Fees reduce by c £230m

Savings on alternatives harder to access

Active management increases transaction costs

		Excess cost relative to passive			
Market	**Passive**	**25% turnover**	**50% turnover**	**75% turnover**	**100% turnover**
UK	0.08	0.20	0.45	0.70	0.95
North America	0.01	0.06	0.14	0.21	0.29
Japan	0.01	0.14	0.29	0.44	0.59
Europe ex-UK	0.03	0.09	0.21	0.32	0.43
AP ex Japan	0.04	0.15	0.33	0.51	0.69
Emerging Markets	0.10	0.20	0.48	0.76	1.04

Even passive management incurs transaction costs
Higher turnover = higher cost
UK impacted by stamp duty

PERFORMANCE

Returns: active vs passive

10 years to end 2011: Index and Weighted Ave. returns (%p.a.) gross of fees

Equity market	UK	North America	Europe ex UK	Japan	Developed Pacific ex Japan	World Pacific ex Japan
FTSE Index	4.8	2.8	4.3	2.5	12.1	10.9
Passive Portfolios	4.8	2.6	4.3	2.6	12.2	-
Active Portfolios	4.9	1.7	4.5	2.0	11.8	11.8

Source: State Street Investment Analytics, July 2012

LGPS aggregate performance

10 years to 31 March 2013: Index and weighted ave. returns (% p.a.) gross of fees

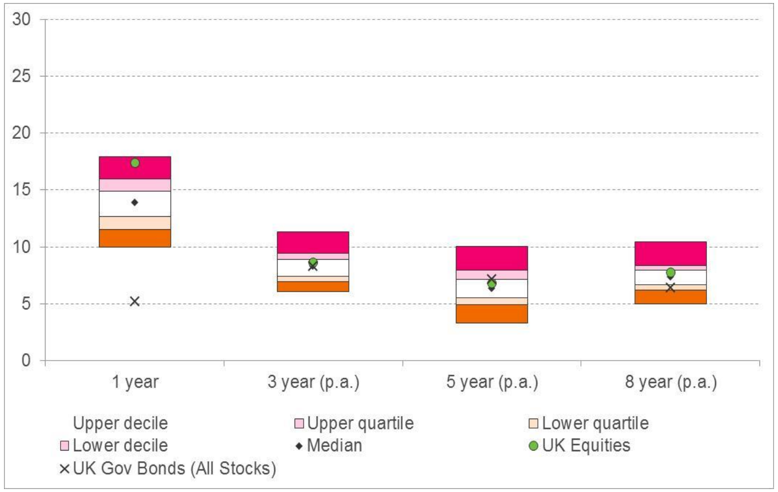
Equity market	UK	North America	Europe ex UK	Japan	Developed Pacific ex Japan	Emerging Markets
FTSE Index	10.7	9.5	11.4	7.4	16.4	18.2
Aggregate LGPS	10.8	8.4	11.6	7.5	17.3	17.1
Excess active return	0.1	-1.1	0.2	0.1	0.9	-1.1
Extra cost p.a. of active	0.34*	0.27	0.20	n/a	0.49	0.53

Sources: State Street Investment Analytics (The WM Company), CEM Benchmarking Inc.

* This is our estimate of the extra cost which reflects the low fees that the LGPS in aggregate pay for active management of UK equities. The global cost premium is estimated by CEM as 0.56%

Dispersion of returns for LGPS

	1 yr	3yrs (p.a.)	5yrs (p.a.)	8yrs (p.a.)
Maximum	17.9	11.3	10.1	10.5
Upper quartile	14.9	8.9	7.1	7.9
Median	**13.9**	**8.3**	**6.4**	**7.4**
Lower quartile	12.6	7.4	5.5	6.7
Minimum	10.0	6.0	3.3	5.0
UK equities	**17.4**	**8.6**	**6.8**	**7.8**
UK gov. bonds	**5.2**	**8.3**	**7.2**	**6.4**



Over 8 years to 31 March 2013
the best performer has beaten the worst by 5.5%p.a.

Fund of funds fees impact on performance

Average value added (%) relative to customised investible benchmarks by implementation style

Asset Class (time period)	Internal	Direct Limited Partnership	Fund of Funds
Private Equity(1996-2012)	6.2	1.8	-0.6
Real Estate (1995-2012)	0.7	-1.1	-4.8

High costs of fund of funds materially impact on performance
Quality and scale of resource required for internal management

IMPLEMENTATION – EMERGENCE OF BENEFITS

Sources of savings

Scenario specified in DCLG brief

- Moving listed assets to passive management
- Reducing/removing the use of fund of funds for alternatives

Costs of change

- Dominant cost is transition of listed assets
- Cost of exiting alternative assets early is too high
  - allow to run off
- Other costs include
  - Costs of establishing a collective investment vehicle
    - Personnel, support and infrastructure
    - The legal structure
  - Cost of management of future investments in alternatives
  - Early termination of existing contractual arrangements
  - Project management, actuarial advice (for third option) and legal costs

Net Present Value of potential savings

- Ten year projections
- Sensitivities to:
  - Extent of the take-up of passive investment
  - Extent of removal of Funds of Funds for alternatives
  - Transition cost
  - Number of collective investment vehicles established; and
  - Level of fee savings achieved.
- Combinations illustrated in report

Net present value of savings over 10 years

Take-up	Savings in manager fees	
	Passive and alternatives	Passive only
100%	2.8	1.7
50%	1.4	0.8
10%	0.2	0.2

Assumes Option 1, i.e.one passive CIV and one CIV for alternatives

Level of take-up significantly impacts the NPV

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NPV – sensitivity to option and transition cost

Transition cost assumption	Option 1 (one passive CIV, 1 alternatives CIV) £bn	Option 2 (5 passive and 5 alternatives CIVs) £bn	Option 3 Merger* £bn
£215m	2.8	2.6	2.0
£240m	2.8	2.6	2.0
£400m	2.6	2.4	1.8

- * Assumptions: 5 passive/ 5 alternative CIVs with 18 mth delay in implementation
- Savings are greater with one CIV rather than five
- If transition cost is contained, higher savings emerge

Merger takes time to achieve so cost savings are slower to emerge

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Sensitivity to options and fee savings on listed assets

Assumption for savings from passive fees	Option 1 (one passive CIV, 1 alternatives CIV) £bn	Option 2 (5 passive and 5 alternatives CIVs) £bn	Option 3 Merger* £bn
Central assumption - £230m across equities and bonds	2.8	2.6	2.0
Lower savings on passive - £200m	2.5	2.2	1.7
Extra savings on passive - £260m	3.2	2.9	2.3

* Assumptions: 5 passive/ 5 alternatives CIVs with 18 mth delay in implementation

Savings over 10 years

- Based on a passive solution, when consistent assumptions are made about …
  - Level of take-up
  - Transition costs
  - Potential fee savings
- … The savings are expected to be greater
  - with one CIV rather than five
  - if steps are taken earlier rather than later
    - merger delays implementation

LEGAL IMPEDIMENTS

Impediments and mitigations (Squire Sanders)

Issue	Resolution
Powers to enact change	
Options 1 and 2 (CIVs) Can funds be compelled to invest exclusively in CIVs?	No power currently exists. Secondary legislation required to change the current investment powers of Administering Authorities
Option 3 (merger) Status of ‘power’ to merge funds (assets and liabilities)	Would need specialist counsel opinion to determine if primary legislation can be avoided and to rebut challenge
Investment Regulations Limits within existing regs will inhibit the flexibility of pooled vehicles to provide the appropriate solutions	Re-draft the Investment regulations (e.g. using a prudential risk framework)

Comparison of pooling vehicles (Squire Sanders)

	Unauthorised Unit Trust	OEIC (UCITS)	Limited Partnership	ACS	Life Fund
Direct ownership of assets by investors	no	no	yes	yes	no
Capital requirements for operator	AIFM	UCITS	AIFM	AIFM	Life Directives (solvency II soon)
Restrictions on investments	QIS limits (mainly real estate)	UCITS limits	QIS limits (mainly real estate)	QIS limits (mainly real estate)	Permitted links restrictions
Tax transparent	yes	no, but favourable tax regime	yes	yes	no but very favourable tax regime
Enhanced insolvency protection	no	no	no	no	policyholders ahead of unsecured creditors
Segregation of sub-Funds	no	yes	no	yes	no
Current limit on LGPS holding	35%	35%	30% in aggregate	?	35%

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THE THREE OPTIONS

The three options

Option 1
A single asset pool, 89 administering authorities remain

Option 2
5 to 10 asset pools, 89 administering authorities remain

Option 3
5 to 10 merged funds,
89 separate LGPS funds replaced by 5 to 10 merged funds

Differences in the three options

- Extent of local decision making retained
  - Under options 1 and 2 local decisions on strategy retained but not investment manager/style choice
- Cost savings
  - Options 2 and 3 may not be optimal scale
- Implementation costs, timescale, payback period
  - Option 3 more costly and takes longest
- Legal issues
  - Potentially more complex for option 3

DELIVERY OF BENEFITS

Quantification of benefits

Cost savings p.a. Value (bps of value of LGPS assets)	How	Timescale
Manager fees		
£230m (12bps)	More passive investment	Within 2 years
£240m (13bps)	Lower cost alternatives	Full annual savings not achievable until year 10
Transaction costs		
£190m (11bps)	Lower turnover	Post transition

Conditions for delivery of benefits

- Legislative changes required
- Large asset pools to maximise scale benefits
- Careful management of any transition to minimise costs (explicit and implicit)
- Allow existing fund of funds investments to run off
- Widespread participation: estimated cost savings are based on full participation

Reliances and limitations

- The information in our report is based upon our understanding of legislation and events as at 12 December 2013 and we have used all reasonable endeavours to ensure the accuracy or completeness of the information used in the report.
- We have relied on data and legal advice provided by our partner organisations in compiling the report, CEM and Squire Sanders, both under sub-contracting arrangements. Whilst reasonable efforts have been made to ensure the accuracy of the data and advice expressed, we cannot verify the accuracy of such advice and data and we cannot be held liable for any loss arising from use and/or reliance on such advice and data.
- It should be noted that we do not provide legal services and therefore, we accept no liability to any third parties in respect of the legal opinions expressed in our report. Third parties are advised to take independent legal advice in respect of any legal matters arising out of our report.

Thank you

Any questions?