



PENSION FUND MANAGEMENT BOARD – 6TH SEPTEMBER 2013

REPORT OF THE DIRECTOR OF CORPORATE RESOURCES

CALL FOR EVIDENCE ON THE FUTURE STRUCTURE OF THE LOCAL GOVERNMENT PENSION SCHEME (LGPS)

Purpose of the Report

1. To inform the Board about the current Consultation in respect of the future structure of the LGPS, and to encourage discussion about what Leicestershire County Council Pension Fund's response to the consultation might be.

Background

2. The minister responsible for the Local Government Pension Scheme, Brandon Lewis, used his NAPF Local Authority Conference address on 21 May to call for evidence on the future structure of the LGPS and measures that might improve efficiency and performance. This call for evidence became a formal consultation on 21st June 2013.
3. Listed below are a number of extracts from the speech which, when taken together, give a reasonable summary of what the call for evidence is attempting to achieve.

"The LGPS has an enviable record on scheme administration and many of you can be proud of what you are achieving. Nevertheless, the scheme has changed little since 1974. Is it still fit for purpose and can it deliver value for money for scheme members, employers and taxpayers?"

"Introducing the new scheme is a clear priority for us all, but since becoming Local Government Minister, I have also been clear that looking at other ways of achieving better value for money for taxpayers is equally, if not more important. After all, you are responsible for vast sums of money. You spend about £8 billion a year on pension benefits, while fund management and scheme administration costs alone are almost £500 million a year."

"Many people associated with the LGPS, including a fair few in the audience today, have been to see me with their ideas. Most of them have said that if there are to be fewer funds, theirs should remain because it's the best."

All of them have raised some important points. For example, most agree that we need to see the costs of administering funds and the fees paid to fund managers reduced. To achieve this, we need a better understanding of the factors driving these costs. In particular, I want to understand why the administration and fund management costs of similar fund authorities can vary so markedly."

"I now want to say something about fund mergers. There is probably no other issue on the LGPS radar that attracts such diverse and forthright views. I recognise the tensions out there, and no doubt in the room today, but I am clear that we must explore every option that might give employers and taxpayers a better deal.

Opinion is clearly divided on the issue of whether "big is better", but for me, the real question is whether "small is worse". There is compelling evidence from around the world to suggest that the scheme could benefit from a smaller number of optimal funds. But some of you contend that small funds can perform on a par with larger ones. Both sides are equally convinced of their case."

"Having the new scheme in place by April next year has to be our number one priority, but at the same time, we cannot afford to just keep talking about structural reform. We need clear objectives and a clear strategy to achieve change.

I was also pleased to learn that a clear consensus had emerged on the need for more focused and better scheme data. Different parties had different ideas about what those needs are, and various attendees said that they would be prepared to lend their experience and expertise in helping to develop a new dataset that better meets today's needs. I see this as an essential first step in the process to reform the structure of the LGPS."

"So what is the way forward? What is clear to me is that things need to change. We need more transparency, better data, fewer unnecessary overheads and stronger, more consistent investment performance."

"The consultation will not set out some pre-determined solution to what is undoubtedly a complex and contentious issue. I am neither ruling anything in nor ruling anything out at this stage. However, the clear message from me this morning is that I am not wedded to the existing number of 89 funds in England and Wales. If it takes a smaller number of funds to improve the efficiency and cost-effectiveness of the scheme, I shall not shy away from pursuing that goal."

"I hope I have left them in no doubt that I see work on structural reform of the LGPS, as well as pension liabilities and fund deficits, being one of their first priorities."

"I want good scheme regulations working within a reformed structure that is cost effective and affordable to those who pay the scheme's costs. I am open to the idea that change itself may have to wait until after the new scheme has been introduced, but I am determined to get you thinking now about what changes we need and how they can be achieved."

4. Although the address leaves all options open, there are many people who feel that there is an inherent bias towards fewer, and much bigger, funds existing in the future. The issue of smaller funds, and the fact that they are arguably sub-optimal in size, is more prevalent within London where each London Borough (of which there are over 30) has a separate LGPS Fund. Merging Funds into between 5 – 8 'superfunds' appears to be an option that will be seriously considered.

Cost Savings/Efficiencies

5. The rationale behind fund mergers is broadly two-fold; bigger investment portfolios will attract lower investment management fees and the ability to employ more and better internal expertise will lead to better investment decisions being made (for example deeper due diligence can be carried out when appointing a manager).
6. A number of LGPS Funds (including Leicestershire) have provided information on their running costs to a specialist investment cost benchmarking service for analysis, and 12 of these funds were combined to arrive at an 'aggregate fund' valued at about £30bn which had broadly the same characteristics, in terms of the individual Fund sizes, as the entire LGPS universe. These costs were then compared to a global universe of individual pension funds that were of similar (£30bn) size and the additional costs of the LGPS Funds equated to about 0.05% p.a.
7. The figures provided by the benchmarking service are only in draft form and, therefore, subject to revision. It is, however, surprising that the extra costs of having twelve individual funds (with substantial variation in size) were so low in comparison to the fees that would be paid by a single £30bn fund with a similar investment strategy. This calls into question the previous thought, in some quarters, that 0.15% (about £250m across the LGPS) could be cut from annual investment management fees.
8. The issue of bigger funds having an inherent advantage by being able to produce better investment performance is very complex as there are so many variables to take into account. As an example, THE main driver of investment performance is asset allocation – how much is invested in equities, bonds, property etc. A Fund with a 50% equity weighting will almost certainly underperform one with a 60% equity weighting when stock markets are rising strongly, but might have taken a deliberate decision that it is uncomfortable with the amount of volatility that a higher equity weighting would bring. If the 10% equity underweighting (relative to the other Fund) was invested in an asset class that produced, over the very long term, a lower but much less volatile performance than equities would this make the decision wrong?
9. There are many other variables that can impact onto investment performance and simply being bigger and having more internal resources is no *guarantee* that performance will be enhanced, although there is global evidence that this is generally the case. Within the LGPS there are some small Funds with very good investment performance and some larger ones with lacklustre performance, but the opposite can also be said.

Local Accountability

10. Within the LGPS there are three sources from which the cash is accumulated to pay benefits; employee contributions, employer contributions and investment returns. Employee contributions are specified within LGPS Regulations, so the combination of employer contributions and investment returns has to pay for the balance of cost. It is literally a case that the higher investment returns are, the lower contribution rates will be (and vice versa). As strategic investment decisions (asset

allocation, manager appointments etc.) are made at local level, there is clear and unambiguous local accountability for the decisions taken. Having bigger Funds, covering a larger area that encompasses a number of County/Metropolitan areas is likely to substantially weaken local accountability for the investment decisions taken.

11. Individual LGPS Funds are relatively divergent in their asset allocation, and it has to be assumed that each has taken decisions based on what it felt to be the correct asset mix for their Fund. Part of the decision-making process will be the risk tolerances of each Fund and views about the possible future risk/return balance for certain asset types; there is no 'right' or 'wrong' answer. As an example of the difference within asset allocation, the average exposure to UK equities is 25% but the range goes from over 40% to less than 10%. Within property the average is just under 7% but the range is nil to 12.6%. Merging Funds runs the risk that a 'one-size-fits-all' approach to asset allocation actually ends up fitting nobody due to the inevitable compromises that would need to be made.
12. There is a possibility that centrally procured 'asset pools' could be created into which individual Funds could invest, thereby retaining local accountability for at least the asset allocation side of the investment decision; in this scenario it is difficult to see how there could be much flexibility for local decision-making in terms of the choice of individual investment managers. This should provide lower fees, but the savings might be considered insufficiently small to justify the change.

Vested Interests

13. As alluded to within the speech by the Minister, almost every Fund has a vested interest in either preserving the status quo (so that they retain autonomy) or in pushing for mergers (because they feel that they will be one of the remaining administering authorities). It is difficult to take a dispassionate view of the matter when you are in the middle of the debate, but this is what is required if sensible decisions which are the best long-term financial interests of the tax-payer (who ultimately 'underwrites' the LGPS) are to be made.

Risks

14. Doing nothing and preserving the status quo is a risk, if the current LGPS structure is unnecessarily expensive and sub-optimal for generating acceptable investment returns.
15. It does, however, appear that forced mergers are a larger risk and that this risk is multiplied if any merger is rushed and not planned rigorously. Funds are already looking at ways to work more closely together to deliver a better outcome and, whilst it could justifiably be said that this should have happened some time ago, there are undoubtedly savings that can be made from voluntary co-operation.

Leicestershire's Response to Call for Evidence

16. It is crucial to remember that this is a call for evidence; it is not a call for opinion or supposition. In this respect it is unfortunate that the consultation period is too short

to actually produce sufficient evidence, across the LGPS as a whole, to be able to form any firm body of evidence about what might be the impact if the current structure was changed.

17. It is too soon to write even a draft response to the consultation, particularly given that the one meaningful piece of 'evidence' (the relatively low saving that could potentially be made in investment management fees) is only in draft form. Leicestershire will, however, respond to the consultation and discussions that are generated by this report will be factored into the response where they are relevant.
18. Without wishing to pre-empt the views of the Board, it currently seems that the case for mergers (particularly between Funds that are already a substantial size) is far from proven. There are undoubtedly some savings that could be made by closer co-operation between Funds, and these will flow through in time and be accelerated by discussions about the future structure of the LGPS.

Questions Posed within Consultation

19. A copy of the consultation letter is attached as an Appendix to this report, and within it there are five questions. These questions are a useful starting point for discussions by the Board, but any response does not have to deal exclusively with answering these questions.

Recommendation

20. The Board is asked to consider the contents of this report and authorise officers to submit a response, having regard to its comments, to the Government's Call for Evidence on the future structure of the Local Government Pension Scheme.

Equal Opportunities Implications

None specific.

Background Papers

Attached as appendix.

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