

SURREY COUNTY COUNCIL**PENSION FUND BOARD****DATE: 20 SEPTEMBER 2013****LEAD OFFICER: SHEILA LITTLE, CHIEF FINANCE OFFICER****SUBJECT: LGPS: CALL FOR EVIDENCE ON THE FUTURE STRUCTURE OF THE LOCAL GOVERNMENT PENSION SCHEME****SUMMARY OF ISSUE:**

The Department for Communities and Local Government has issued a call for evidence on the future structure of the Local Government Pension Scheme. This paper sets out a summary of the various issues that need to be considered.

RECOMMENDATIONS:

It is recommended that:

- 1 The Pension Fund Board discuss the issues with a view to offering views and observations for the compilation of a formal response by the Board to be finalised by the Chief Finance Officer in consultation with the Chairman of the Pension Fund Board.

REASON FOR RECOMMENDATIONS:

The outcome of this process will affect the way in which the Surrey Pension Fund is administered. Therefore, the Pension Fund Board should take a full part in the consultation process.

DETAILS:**Background**

- 1 On 21 June 2013, the Department for Communities and Local Government issued a call for evidence on the future structure of the Local Government Pension Scheme. The document is included as Annex A.
- 2 The document is set out as a “call for evidence” and therefore required to show “evidence” rather than opinion. Although the Department for Communities and Local Government (DCLG) and the Local Government Association (LGA) would like to assess hard evidence during the consultation period, the questions actually leave some room for opinion.
- 3 The call for evidence indicates that the response should have particular but not exclusive regard to the questions and it would be helpful for members to indicate whether there are any other issues they would want addressed in the response.

Objectives

- 4 The document sets out high level and secondary objectives for reform. These are:

High level objectives

- a) dealing with deficits
- b) improving investment returns

Secondary objectives

- a) reducing investment fees
- b) improving the flexibility of investment strategies
- c) providing for greater investment in infrastructure
- d) improving the cost effectiveness of administration
- e) providing access to higher quality staffing resources
- f) providing more in-house investment resource

Approach to the Questions

- 5 There are five questions and these can be referred to in the Annex 1 as well as being set out below. The themes of the questions are accountability, objectives, options analysis and data requirements.

- 6 Q1 on Accountability: this is about the accountability of any (potentially restructured) entities running the LGPS funds. It also relates to the extent to which consultees feel it is important to retain local decision making with regard to their specific Funds.

Q2 on Objectives: this question asks for opinion on whether these are the right objectives and therefore responses can only be opinion based.

Q3 & Q4 on Options Analysis: this question asks to what extent the options under consideration would meet the two primary and six secondary objectives. Evidence based responses would be welcome but where data is not available, opinion should be offered.

Q5 Data: the question asks what data should be collected and how should it be analysed. The question suggests that the Department acknowledges that data for deciding the way forward is not all available yet and may need to be gathered, even after the consultation ends.

- 7 In summary, the DCLG will welcome any evidence that is available but, where it is not, there must be an element of opinion in response to the DCLG's consultation. Each of the questions is addressed below:

- 8 **Q1: How can the LGPS best achieve a high level of accountability to local taxpayers and other interested parties, including through the availability of transparent and comparable data on costs and income, while adapting to become more efficient and to promote stronger investment performance.**

9 A cornerstone of the current structure is the concept of local accountability. Any alternative proposal would need to demonstrate the preservation or otherwise of local accountability. Various alternatives could certainly result in the loss of local decision making on matters such as investment risk, asset allocation and deficit recovery plans. Such decisions have a direct impact on local taxpayers and the concept of local accountability could be diluted.

10 **Q2: Are the high level objectives listed (dealing with deficits and improving investment returns) those we should be focusing on and why? If not, what objectives should be the focus of reform and why? How should success against these objectives be measured?**

11 This is agreed. Achieving 100% fund levels is the most important investment and funding objective. Improving investment returns is one of the tools to achieve that objective.

12 **Q3: What options for reform would best meet the high level objectives (dealing with deficits and improving investment returns) and why?**

Deficits

13 The various alternative frameworks for fund mergers will have no immediate effect on funding deficits and could significantly increase the range of funding deficits across the participating employers within a single fund. Permutations will exist amongst employers in a single fund who are regarded as having a strong or weak covenant, being well or poorly funded, and operating on a long or short time horizon. Whatever the framework, the deficits will need to be managed and, whether or not this can be better achieved via the existing LGPS arrangement or an alternative structure, only time and experience will tell. Regardless of the framework chosen, deficits will need to be tackled with additional contributions and improved investment performance from growth assets.

14 The starting point will be comparable data on fund deficits. We will need disclosure of funding levels and deficits using like-for-like assumptions. There is currently a huge range of actuarial assumptions used in liability calculations. It should be said that funds can justify varying actuarial approaches to setting contributions according to their unique liability profiles and the associated investment strategies.

Investment returns

15 For most long term, secure LGPS employers, a common investment strategy might suffice. However, within an alternative structure, there could be increasing diversity amongst employers due to outsourcing and the resultant better or worse funding levels. Well funded employers may be able to reduce investment risk now, while poorly funded employers may not be able to reduce risk so easily. One investment strategy will not fit all, and a move to multi-investment strategies within one super fund will be necessary. These various permutations will each require the selection of a best-fit investment strategy. The desirability of having some influence on the level of investment risk could become important if gilt yields rise quickly because the impact on deficits for individual employers may vary greatly in this environment.

16 It is argued that diseconomies of scale could apply with some alternative frameworks, especially with the use of external active managers, and possibly greater use of passive funds would result. The current structure of collaboration and cooperation between funds will enjoy the benefits of reduced market impact, diversified risk, whilst benefitting from lower expense ratios. There is currently conflicting evidence with respect to the positive effect of scheme size on performance in the global pension fund industry and some have argued that there are diseconomies of scale when investing in listed equity securities due to market impact costs and execution delays.

17 The larger schemes generating superior returns have done so through increased allocation to alternative investments at favourably negotiated terms, whilst using internal staff to manage active strategies. This may have implications on asset allocation decisions (active or passive, liquid or illiquid, traditional or alternatives) and the composition and remuneration of the investment professionals. Evidence from other countries suggests that scale benefits could improve net of fees investment performance but there is no definitive proof that bigger is better. There is also much negative experience associated with large funds overseas.

18 **Q4: To what extent would the options you have proposed under Q3 meet any or all of the secondary objectives? Are there any other secondary objectives that should be included and why?**

Infrastructure

19 The important point here is that such projects must be relevant to the investment and funding objectives of the fund. Whilst LGPS funds can be a valid source of funding for infrastructure projects, a long term tie up and lack of liquidity must fit in with the fund's liability profile. Alternative structures are not necessary to enable investment in infrastructure. The pooling of infrastructure assets in common investment funds will enable access to infrastructure investment at reasonable fee levels.

Cost Effectiveness of Administration

20 Various initiatives exist with regard to reducing administration costs. These include various forms of shared services, voluntary mergers of individual fund administration staffing and funds competitively tendering for the provision of other funds' administration services. All of these initiatives have not had to rely on structural change in the way that Funds are currently administered. It could be argued that the cost effectiveness of administration should not be included within the criteria for change necessity.

Higher Quality Staffing Resources

21 Attracting and retaining in house talented investment professionals paid at private sector rates at or above local authority director level could prove challenging (but not insurmountable), given that the new funds would almost certainly be run by existing LGPS administering authorities.

In House Investment Resources

- 22 The larger LGPS funds predominantly employ in house investment staff. Further recruitment of professionals to run active strategies in house could result if the number of LGPS funds was significantly reduced. Much of the current debate suggests that alternative proposals regarding fund structures are about gaining bargaining power on manager fees. Moreover, there exists a so called "governance dividend" arising from more responsive governance arrangements, more in-house specialist resources and more diversification by fund manager and asset class associated with larger funds.
- 23 **Q5: What data is required in order to better assess the current position of the LGPS, the individual Scheme fund authorities and the options proposed under this call for evidence? How could such data be best produced, collated and analysed?**
- 24 A valid business case for change can only be made with precise and consistent costings as to current and future proposed structures. Accurate LGPS cost information is required, especially with regard to administration and investment management costs. Currently, there is a wide range from lowest to highest unit costs and inaccurate data is considered part of the reason. Poor and inconsistent costings, especially with regard to the different treatment of pooled fund fees, will continue to cause inaccurate and unfair comparisons to be made between funds.
- 25 Accurate costings arising from any of the proposed alternative structures and the quantification of future potential benefits are required. Such costs could be considerable and could include the set up costs for the alternative frameworks and fund transition costs. The project cost, benefits and viable payback period must be demonstrated. There is currently no suggestion that merger costs would be borne by anyone apart from the LGPS funds themselves. This makes an accurate cost benefit analysis absolutely vital in the decision making process. As things stand, no one is really sure how strong the business case for any alternative is.

CONSULTATION:

- 26 The Chairman of the Pension Fund has been consulted on the Call for Evidence and has offered full support for the narrative set out in this report.

RISK MANAGEMENT AND IMPLICATIONS:

- 27 There are various risk issues contained within the Call for Evidence document and the report narrative.

FINANCIAL AND VALUE FOR MONEY IMPLICATIONS

- 28 Financial and value for money implications are set out within the report narrative.

CHIEF FINANCE OFFICER COMMENTARY

- 29 The Chief Finance Officer is satisfied that all material, financial and business issues and possibility of risks have been considered and addressed and that responding to the call for evidence will offer a clear path for the provision of evidence and opinion, reflecting the views of the Pension Fund Board.

LEGAL IMPLICATIONS – MONITORING OFFICER

- 30 A new future LGPS structure will give rise to various legal implications and legislative requirements, possibly from 2014 onwards.

EQUALITIES AND DIVERSITY

- 31 The response to the call for evidence will not require an equality analysis, as the initiative is not a major policy, project or function being created or changed.

OTHER IMPLICATIONS

- 32 There are potential implications for council priorities and policy areas that will become clear if a new LGPS structure is proposed.

WHAT HAPPENS NEXT

- 33 The following next steps are planned:
- Respond to the Call for Evidence by the deadline (27 September 2013).
 - Further report to the Board following proposals due to be published before end of 2013.

Contact Officer:

Phil Triggs, Strategic Finance Manager (Pension Fund and Treasury)

Consulted:

Pension Fund Board Chairman

Annexes:

Local Government's call for evidence on the future structure of the Local Government Pension Scheme: June 2013

Sources/background papers:

None
