Call for evidence on the future structure of the Local Government Pension Scheme – Response on behalf of the Lancashire County Pension Fund

The Lancashire County Pension Fund provides the Local Government Pension Scheme (LGPS) in the County of Lancashire allowing a means of pension saving for nearly 144,000 scheme members and 253 employers ranging from local authorities to multi-national companies and small local charities. The Fund had assets at the end of March 2013 of just over £5bn and is one of the top ten LGPS funds by this measure.

The Fund has a successful record of collaboration and successfully provides pensions administration services on a shared service basis to Cumbria County Council and the Lancashire Police and Fire-fighter's schemes. The Fund has also jointly procured a range of services including actuarial services with neighbouring funds.

The Fund welcomes the opportunity to respond to the call for evidence on the future structure of the LGPS and looks forward to the process of reform continuing in the positive and constructive manner that has been evident in most of the country to date.

In answering the questions posed in the call for evidence, we start from the proposition that there is no inherent logic that says that larger funds perform better than smaller funds, or that small is beautiful. In investment terms the LPFA Fund, one of the larger funds, has tended to underperform while the Orkney Fund, one of the smallest, has tended to perform very well. Equally, the very large Greater Manchester Fund has performed well and Shetland performs poorly. Thus we can read nothing into the size of funds and a disruptive top-down driven series of fund mergers to create a small number of regional "super-funds" would likely be costly and detract from performance in the medium term as funds focus on the merger process.

The thinking behind the call for evidence seems to be that a smaller number of larger funds will inevitably pay less and perform better. There is no evidence to support this. The Lancashire fund already pays managers' lowest tier of fees due to the size of mandate which it awards and is able to negotiate "most favoured nation" terms which mean that it will always pay the manager's lowest fee, While it is accepted that this is not the case for smaller funds, the scale of savings which might be achieved through squeezing managers are insignificant in the context of the real issue which faces LGPS funds which is the scale of funds' liabilities and hence the size of the deficit which needs to be addressed, through the delivery of successful investment and liability management strategies.

A central theme in the Minister's speech at the NAPF Local Government Conference launching the call for evidence was the need to professionalise the running of LGPS. We would support this and in the running of the Lancashire County Pension Fund we have already taken steps to move away from the traditional model of most funds which sees the running of the Pension Fund as something undertaken by certain key staff effectively in their spare time. In most cases the financial scale of local authority pension funds is much greater than that of their host authorities and we do a disservice to scheme members if we do not place sufficient management focus and skill into the way in which we exercise our responsibilities for these funds.

Dealing with the questions in the Call for Evidence in turn:

Question 1 – How can the Local Government Pension Scheme 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.

The first question to deal with here is to whom should funds be accountable? There is a strong argument that, as pensions are deferred pay, funds should be accountable to beneficiaries. Equally given that the deferred pay is funded by the taxpayer there should be accountability to the employer who represents the taxpayer. Both are valid cases and while the focus has understandably been on employers and taxpayers the importance of accountability to beneficiaries must not be underestimated and we welcome the proposals in the consultation on governance arrangements to strengthen the voice of beneficiaries in the oversight of schemes.

Accountability might be thought to mean any combination of the following:

- The ability to influence the level of contribution rates;
- The ability to influence investment strategy and risk appetite;
- The ability to challenge performance in the fields of both investment and administration.

So how is accountability best exercised? Certainly the publication of information in an accessible and understandable form is central to this and there are already requirements on funds to publish a great deal of information and to formally consult on the production of a range of key policies and strategies.

Our view would be that the current range of requirements on Funds in relation to what has to be published and consulted on, and the degree of prescription on the content of particular documents, encourages a tick box mentality which actually stifles the process of engagement with stakeholders that would result in enhanced accountability. Somewhat more freedom within an overall regime which encourages openness and dialogue seems likely to encourage innovation in terms of engagement with various different groups of stakeholders.

Generally neither employers nor employees are able to "shop around" between pension funds and therefore while comparative information on fund performance may be interesting, the "killer" pieces of information are the absolute return achieved by the Fund and the funding level. If a relative performance benchmark is required, the best one that we have identified is performance relative to the assumptions made by the actuary in setting contribution rates. Out-performance against this measure means that any deficit is being eroded quicker than planned, thus it is meaningful in the fund specific context.

There is potentially a degree of conflict between the overall objectives of the Fund, which are to ensure that resources are available to ensure benefits can be paid, and the desire of employers and taxpayers for reduced contribution rates. The Fund must have regard to the affordability and sustainability of contribution rates, but we cannot reach a situation where employers are given some form of veto mirroring the council tax referendum process. This could result in funds being run in an imprudent manner and would be acting entirely counter to the best interests of scheme beneficiaries. Thus we need to be clear how far accountability to stakeholders should go. The tension highlighted above may become greater with the increased involvement of the Pensions Regulator and the greater read across that seems to be intended from the governance arrangements that apply in private sector funds where accountability to key stakeholders such as sponsors seems relatively weak and the interests of beneficiaries predominate. This is likely to be appropriate in the private sector where schemes are trust based. The situation in the public sector is different and this must be understood and reflected in the arrangements that are arrived at.

Question 2 – Are the high level objectives listed above those we should be focussing on and why? If not, what should be the focus of reform and why? How should success against these objectives be measured?

While the sentiment of these two objectives is right, the focus is wrong. We would suggest that the objectives should be framed in terms of:

- Ensuring that funds are available to meet pension promises when due (i.e. the management of fund cash flows);
- Achieving a fully funded and sustainable scheme within the timescale set by the actuaries. (i.e. the elimination of the deficit).

The delivery of increased investment returns is simply one tool to achieve these objectives and in some cases may not be the appropriate tool to use if it fundamentally changes the investment risk balance in a way that is inappropriate to the overall liability profile.

Reform of any sort needs to make the achievement of these objectives more likely in the medium term than the maintenance of the status quo.

The way in which we have framed the two objectives makes for simple and easily understandable measurement:

- In terms of fund cash flows this is the net flow of cash (i.e. excluding unrealised gains and losses on investments) into the fund from all sources, further sophistication could be added by splitting the measure between dealings with members and investment income.
- In terms of funding level each triennial valuation will create a "glide path" that shows the funding level improving over time. The simple measure is for actual funding to be measured against this glide path. The actuarial firms now provide funds with tools using rolled forward data which allow a reasonable estimate of the funding position to be made at any point in time.
- To reinforce the funding level investment performance should also be measured against the actuarial assumption, the reason for this being that in many cases it is the movement in liabilities rather than poor investment performance that has caused deficits not to reduce in line with the glide path, therefore there is some merit in looking at investment performance as an independent secondary measure associated with the funding level.

Using two primary measures and one secondary measure in this way provides a relatively easily understandable way of gauging success by looking at outcomes rather than at inputs.

Question 3 – What options for reform would best meet the high level objectives and why?

Our clear preference is to create a climate where greater collaboration between funds is encouraged on the grounds that this creates the opportunity to achieve at least some of the secondary objectives outlined within the call for evidence without diluting the current level of accountability to scheme employers and beneficiaries.

As stated above we do not accept the argument that larger funds are necessarily better than smaller funds. What is important is whether the strategy is right and its implementation is managed properly and that those overseeing the Fund have access to the appropriate levels of advice, knowledge and skill to be able to deliver a strategy that is right for a fund of any particular size.

It is clear that in order to deliver the sorts of strategy that will help LGPS deliver improved funding levels and address the issue of liabilities there is a need to build on the various concentrations of intellectual capital which exist across LGPS but which are not necessarily available to all funds. There are means of doing this which do not need to involve the structural upheaval which the merging of funds would necessitate.

These might include the creation of investment management teams shared between funds, and thus provide all funds with access to a level of in-house resource able to challenge the easy nostrums sold by many of the investment consulting firms who operate as the de facto overall managers of some LGPS funds.

There is, perhaps, the opportunity for some smaller funds to achieve the same or better returns with lower fees by the creation of some form of pooled investment vehicle, e.g. five or six small funds pooling their active equity mandates as one mandate in order to achieve a critical mass for investment. Equally there are things larger funds could do, in the form of market led solutions, which could offer assistance to smaller funds and some benefit to the larger fund. For example as a way of achieving some turnover in a private equity portfolio the larger fund could parcel some of its investments into its own fund of funds and sell interests to smaller funds. This would allow the smaller funds to achieve access to a valuable form of investment that they might otherwise not be able to achieve and allow the larger fund both to turn over a portfolio which can be desirable to achieve better balance for example in terms of exposure to different vintages and achieve an income stream from management fees although this is unlikely to be as much as the 1 and 10 (plus the 2 and 20 in the underlying funds) that exist in a more commercial fund of funds.

Our feeling is that means of encouraging greater sharing and, importantly, joint funding of expertise between funds is desirable, This can be achieved without impinging on the sovereignty that exists in an individual fund and Pension Committee which would result in reduced accountability.

It may be the case that there should be a minimum size for funds either in terms of membership or assets, but given that funds outside London cover County areas (whether Shire or Metropolitan) these would seem unlikely to fall below any logical minimum based on the current range of sizes of funds. London is, we would suggest, a different issue, but one which London funds should sort out amongst themselves.

The key question for the proponents of fund mergers is how accountability to the employers and tax payers is to be retained in a situation where a fund covers say two counties and the administering authority is one of them. The logic would be that there would have to be some sort of movement to the model in South Yorkshire where there is in effect a separate joint authority. However, this ignores the complexity of local government in the shire areas, Thus South Yorkshire can easily achieve representation of all the individual constituent districts within a manageable committee. If we were to posit the merger of the Lancashire and Cumbria funds as an illustration to achieve one representative per local authority ignoring other employers and beneficiaries the Committee would be 22 as a minimum, This sort of arrangement would be unmanageable but as direct representation is reduced in a structure that is more separate from a single administering authority with which employers have a much wider relationship and engagement, they will begin to feel that the Fund is unaccountable and remote to a greater degree than is the case at present. Clearly any sensible arrangements for managing such a Fund would seek to counteract this, but it is an almost inevitable effect.

It is also, though equally the case that the single fund in Northern Ireland operates through the appointment of its equivalent of the Pensions Committee through the formal public appointments process and currently has no councillors on the committee. Clearly Northern Ireland does represent a unique set of circumstances, but this move to a sort of "professional trustee" model analogous to the private sector is more likely to address the sorts of conflict of interest issue which the Pension Regulator will see in the current arrangements. It does, however, make achieving direct accountability to the various stakeholders directly affected by the decisions of the Pensions Committee much more difficult to achieve.

Thus it would seem that if we are to maintain some form of direct accountability some form of enhanced collaboration will result in the greater professionalisation of the operation of the scheme that the Minister wants to see.

Question 4 – To what extent would the options you have proposed under question 3 meet any or all of the secondary objectives? Are there any other secondary objectives that should be included and why?

In general terms the secondary objectives, while logical in their own right, do not flow, as might have been expected from the primary objectives. With one exception they represent sensible objectives which it is difficult not to support. To take each of them in turn:

Reduced Investment Fees

Collective investment vehicles and the development of concentrations of in-house expertise to both run money directly and negotiate with external managers clearly give the opportunity to do this. The scale of reductions achievable will be limited to those already achieved by the larger funds which have secured "most favoured nation" status in their fee agreements.

To improve the flexibility of investment strategies

The greatest opportunity here is not related to structural reform of the LGPS but the application of the EU Public Procurement rules to the appointment of managers for segregated accounts. This significantly hampers the flexibility and speed with which funds can act if they need to. A situation which makes available greater levels of in-house resource particularly with skill and expertise in the techniques which allow liability risks to be managed will certainly increase flexibility. However, funds will need to be prepared to make the upfront investment in their in-house teams in order to maximise the potential benefits.

To provide greater investment in infrastructure

We believe the inclusion of the promotion of investment in a particular asset class within a list of potential objectives for the structural reform of LGPS is fundamentally misguided and is likely to set a dangerous precedent if agreed.

The money within local government pension funds is held on behalf of the beneficiaries and must be invested to meet the investment objectives and not to meet political objectives.

Many pension funds, including Lancashire, are already invested in infrastructure funds and committed to further investment, but these are investments chosen because they are the right investments on the right terms and not because they are a particular form of investment.

To improve the cost effectiveness of administration

The Lancashire and Cumbria funds provide a strong case study in the financial and other benefits that can be achieved through collaboration in the area of administration. The administration service in Lancashire took on work previously delivered by a poorly performing private sector contractor and has both improved the quality of service delivered to scheme members and the fund as a whole. This has delivered considerable savings for Cumbria as well as upfront investment in new technology which provides the bedrock for improved customer service. This demonstrates what can be achieved by willing partners without the unnecessary distraction of mergers.

To provide access to higher quality staffing resources

To provide more in-house investment resource

Certainly the ability to create stronger in-house teams should deliver this, but we would argue that this does not in itself require either collaboration or the creation of larger funds. It is a matter for administering authorities to decide how they want to run their funds. Traditionally many have chosen to see the running of the pension fund as an add on to the work of one or more members of staff within the finance department. Having reflected on this we have taken a different view and recruited a strong in-house team with backgrounds in the financial services world, a decision that has paid dividends both in terms of improved performance and reduced fees as well as the identification of strategies which reduce the exposure of the fund to equity volatility while maintaining returns. While the benefits achieved by the team have justified the investment there is a danger in creating small pockets of expertise and sharing a resource such as we and some other funds have developed is a simple, and relatively low cost, method of delivering these benefits across the whole of LGPS. If any message should come through clearly in our response it would be that if we professionalise the running of LGPS, then structure is irrelevant. The running of pension funds is a big business in its own right, most are many times larger in financial terms than the budgets of their administering authorities and we should not treat it as a part time adjunct to other work.

Question 5 – What data is required to better understand the position of the Local Government Pension Scheme, the individual Scheme fund authorities and the options proposed under this call for evidence? How could such data be best produced, collated and analysed?

We are somewhat perplexed by the fact that the data available within the LGPS is suddenly inadequate. If data has been as poor is portrayed for so long it has been within CLG's gift, as the regulator for the sector to remedy the situation.

We outlined our suggested measures of success in answer to question 2 and we feel that these should be central to any revised collection of data. However, we would accept that there is a benefit in collecting other cost and volume data for funds in order to promote the process of continuous improvement across LGPS. However, to be of real use these data must be comparable.

At the heart of achieving comparable data are clear and easily understood definitions of the data items to be reported, which should preferably avoid funds having to apply judgements to source data in order to allocate items to the correct headings. Anecdotal evidence would indicate that there are differences of understanding of the current definitions across LGPS funds.

There are a range of concerns expressed around the way in which charges between host councils and funds are calculated, which are leading some to call for more prescription in this area. Given the professional obligations on the section 151 officers of administering authorities we do not feel more prescription is justified. However, it is entirely right that Pension Committees should periodically review and if necessary challenge the levels of cost charged to Funds by the administering authority. There are ways of making these charges more transparent, for example in the case of Pensions Administration the Lancashire Fund has a clear service level agreement with the County Council which sets a cap on the per member charge of the lower quartile of shire county funds in the SF3 return. A per member charge is the way in which an external provider would charge and this provides a clear comparison in terms both of performance and value for money. The promotion of similar quasi-contractual arrangements for other elements of the costs charged to funds would promote greater transparency and understanding.

There are significant issues with the reporting of investment management fees, as depending upon the way in which investments are made the fees may be transparent or as in fund of funds type investments somewhat more opaque. It would perhaps be helpful for such fees, including in-house investment costs to be compared using the standard measure of bps relative to assets under management. However, it needs to be accepted that different investment strategies will lead to different fee levels and the data should not be used to reinforce a drive towards a common low cost investment strategy. The costs of delivering a strategy must be seen in the context of whether or not it has delivered its objectives. Almost all funds participate in the WM local authority universe which measures investment performance although there are felt to be some limitations with this and simply looking at a local authority universe and the understandable focus on the performance of funds within the local authority league table means that these data are not as useful as they might be.

Given that the data collection machinery for the SF3 return already exists within CLG it would seem sensible to maintain this as the means of data gathering, although there might be merit in transferring these responsibilities and the associated resources to the new Scheme Advisory Board. This will give greater ownership of the product by Funds and provide a forum which can encourage discussion of the results across the scheme which is not the case at present.