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Nottinghamshire County Council

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Call for evidence on the future structure of the Local Government Pension Scheme
Response from Nottinghamshire County Council Pension Fund

The call for evidence issued by the Department for Communities & Local Government and the Local Government Association posed five questions seeking to gain views on accountability, deficits and investment returns within the Local Government Pension Scheme (LGPS). The full response to the call for evidence as approved by the Nottinghamshire Pension Fund Committee is attached and key points are highlighted below.

Accountability to local taxpayers and other interested parties
The LGPS already has a very high level of accountability to local taxpayers, fund employers and member representatives and this will be increased further by the governance changes being introduced by the Public Service Pensions Act 2013. Merging funds will inevitably reduce accountability as governance is removed from the communities in which the fund operates.

The Nottinghamshire fund, in common with many, already publishes a whole range of documentation and data. This should be collated centrally and presented in one place and the new Scheme Advisory Board should play a key role in collating and analysing this data across the LGPS. Comparability between funds could be improved by better pension fund specific accounting guidance but, as each fund has to interpret the guidance to meet its own particular circumstances, full comparability will never be achieved (even with merged funds).

Investment performance and deficits
The current focus on fund deficits is fundamentally flawed and is not helpful to the long term sustainability of pensions. Deficits are estimated and the biggest impact comes from the discount rate used by the actuaries. A movement of just 0.1% in the discount rate changes the Nottinghamshire fund's liabilities by over £125 million. Across the LGPS as a whole, such movements in liabilities would far outweigh any cost savings that can be achieved through merged funds.

Reform should focus on finding a better way to assess the financial position of funds and their ability to pay future pensions.

Investment performance will be volatile so should be viewed over a long term horizon (eg 10, 20 or more years). A sensible investment strategy, simply executed is more likely to out-perform over the long term than a complex strategy. The main change needed is to encourage the focus of reporting and decision-making to be far less on short term returns and more on the medium to long term, both by funds themselves and by asset managers. The evidence of the benefits of in-house management should be discussed more widely.

Simpler investment strategies will inevitably mean lower fees. Collaboration between funds is already providing savings on many services and may also act to reduce investment fees. This would be improved further with central assistance from the Government Procurement Service (GPS). Closer liaison with actuaries and fund employers to manage risks will help to maximise contribution income and this will potentially far outweigh the cost of additional resources to be able to do this effectively. Merging funds will not reduce the number of employers and will make close liaison more difficult.

Next Steps

The call for evidence acknowledges the need to provide robust evidence to support options for change. Before considering merging funds proper evidence should be collated to determine whether 'bigger means better' in terms of investment returns. Analysis should also be carried out of the correlation of returns by manager to assess the risk of all funds underperforming at the same time. Having locally administered funds has the benefit of diversification of investment risk which may protect the LGPS as a whole compared to super-funds.

The new Scheme Advisory Board should play a key role in collating and analysing data in order to report openly about the advantages **and** disadvantages of any proposals for change before any decision is made on the future structure of the LGPS.

Yours faithfully,

S M Smedley

Cllr Stella Smedley MBE JP
Chair – Nottinghamshire Pension Fund Committee

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Call for evidence on the future structure of the Local Government Pension Scheme

Response from Nottinghamshire County Council Pension Fund

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.

High level of accountability to local taxpayers and other interested parties

The LGPS already has a very high level of accountability to local taxpayers through the quasi-trustee role of locally elected councillors. This is a key element of the LGPS, giving direct accountability to the community in which the major employers operate and in which a majority of fund members live. This accountability also helps to ensure high standards of professionalism in the 'trustee' role. The level of involvement by employer and member representatives is also high in the majority of funds including Nottinghamshire. The changes being introduced by the Public Service Pensions Act 2013 will increase this accountability further. Increased central co-ordination and oversight of governance arrangements by the Pensions Regulator or scheme advisory board would ensure that the high standards that exist across the majority of the LGPS can be widened to include all funds.

Merging funds into larger funds will inevitably reduce the accountability to local taxpayers as there would be a greatly reduced role for locally elected councillors. The governance arrangements for a merged fund are, as yet, unclear but they are unlikely to involve the same degree of oversight by persons directly elected by taxpayers. Accountability to the employers would also reduce as governance is removed from the communities in which these employers operate.

Availability of transparent and comparable data on costs and income

There is a huge amount of data already available on the LGPS. Each fund is required to produce accounts and an annual report as well as publish a range of policy statements. Increasingly, authorities are publishing these on-line – the Nottinghamshire fund website currently has annual reports going back to 2002/03 and the last three triennial valuation reports (dating back to 2004). The website (www.nottspf.org.uk) is a key way the fund keeps in touch with its 38,000 active members, 35,000 deferred members and 30,000 pensioner members. Annual reports are also submitted each year to CIPFA and these could easily be published in a central location to make access even easier.

Pension fund accounts are currently produced under the CIPFA Code on the basis of International Financial Reporting Standards (IFRS). One of the main aims of IFRS is to increase comparability of accounting statements. However, a greater involvement by CIPFA in the debates around pension fund accounting and more emphasis on pension fund specific guidance (rather than just example accounts) would help to increase this comparability. It must be remembered, however, that each fund has a different funding position, membership profile and, consequently, investment strategy and so full comparability will never be achieved. This would still not be achieved with merged funds as each super-fund would still be required to interpret the accounting guidance to meet the individual needs of that fund.

Adapting to become more efficient
The LGPS, in common with the whole of local government, is constantly adapting to become more efficient. Collaboration between funds in sharing information and in procurement is increasing rapidly and the framework agreements currently in place have been well received. These frameworks, and the ongoing work to produce new agreements, has so far relied on the goodwill and resources of a few funds. There appears to be no central assistance, for instance, from the Government Procurement Service (GPS). Pension fund procurement requirements are very different from those of the rest of local government (and even the wider public sector) and this should be recognised by the GPS.

The governance arrangements within the LGPS are already very efficient. Having local councillors as 'trustees', means that there are few additional costs involved resulting in a very cost effective system.

Promote stronger investment performance
It is important to remember that investment performance is not necessarily driven by how cheap (or expensive) the management arrangements are or how efficiently the investment services were procured. Investment performance relies to a large extent on existing market conditions and current and future economic situations. This means that performance will be volatile so should therefore be viewed over a long term horizon (eg 10, 20 or more years). The WM Company has recently produced research that indicates that simpler investment management structures tend to out-perform over the long term. The Nottinghamshire Fund's performance has been good partly because we have not constantly switched strategies and managers. Both need time to demonstrate whether they are working, particularly as the costs involved in changing can be high.

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

Are the high level objectives listed above those we should be focussing on and why? If not, what objectives should be the focus of reform and why?
The aims of the Nottinghamshire fund are to:

- enable employer contribution rates to be kept as nearly constant as possible and at reasonable cost to the taxpayers, scheduled, resolution and admitted bodies
- manage employers' liabilities effectively
- ensure that sufficient resources are available to meet all liabilities as they fall due
- maximise the returns from investments within reasonable risk parameters

These aims clearly encompass within them the desire to 'deal with deficits' and 'improve investment returns' and, in addition, all of the elements specified in question 1. This demonstrates that we are already focusing on all of the issues included within the call for evidence as part of day to day business.

It is necessary to note that deficits are estimated and, because the cashflows involved are over a considerably long time, the biggest impact comes from the discount rate used by the actuaries (which is itself determined from a variety of assumptions). Sensitivity analysis carried out by the actuaries shows that, for Nottinghamshire, a movement of just 0.1% in the discount rate changes the fund's liabilities by over £125 million. As one of the main components of the discount rate, increasing bond yields could, at a stroke, wipe out the deficit. Across the LGPS as a whole, such movements in liabilities would far outweigh any cost savings that can be achieved through merged funds.

Deficits are therefore only one indicator of a fund's position. Equally important is ensuring sufficient cashflow to pay pensions. Reform should focus on finding a better way to assess the financial position of funds and their ability to pay future pensions.

How should success against these objectives be measured?
A successful pension fund is one that can pay pensions as they fall due at reasonable cost to employees and employers (and, by extension, taxpayers for a public service scheme). The key to measuring success is therefore establishing a reasonable method of assessing a fund's ability to pay future pensions. Current discussion and reporting focuses almost exclusively on the actuarial calculation of liabilities (and consequent deficit). This approach is fundamentally flawed as this 'calculation' is an estimate based on a number of assumptions and is not helpful to the long term sustainability of pensions. The result of this focus can clearly be seen in the private sector where very few defined benefit schemes exist leaving high levels of risk and uncertainty around pension provision. Ultimately this will place extra burdens on tax payers through additional state pension and benefit payments.

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

Dealing with deficits
It is necessary to change the triennial valuation priorities to focus on a fund's real ability to pay pensions over the short, medium and long term. Focusing on one liability figure, affected hugely by the assumptions within the discount rate, is unhelpful and creates unnecessary concern within the wider public. Pension funding is not a simple issue and shouldn't be treated as such.

IFRS is currently being challenged as being unsuitable for accounting for banks. International Accounting Standard 19 (IAS19 Employee Benefits) is equally unsuitable for reporting pension liabilities (particularly for public sector schemes where sponsor risk is negligible). The treatment and reporting of an employer's pension liability as if it were a trade creditor due to be paid within 30 days is wholly inappropriate for pension benefits payable over decades.

Closer liaison with actuaries and fund employers to manage risks and maximise income to the fund would be of huge benefit and this is something that Nottinghamshire, along with other funds, is already doing.

Improving investment returns
There is no secret formula to improve investment returns. As pointed out above, returns depend on a wide range of factors, mostly out of the direct control of even the biggest funds. Chasing 'flavour of the month' investment strategies and changing every year or two will not help to provide sufficient long term returns (and may dramatically increase costs). A sensible strategy, simply executed is far better than a complex strategy involving multiple managers in multiple asset classes. Esoteric investments dreamed up by asset managers and investment banks are more likely to create unintended consequences and cause massive damage to long term returns. In-house investment may help to improve long term returns as there will generally be less focus on short term gains and trends. Both of these approaches are backed up by evidence from WM.

The main change needed is to encourage the focus of reporting and decision-making to be far less on short term returns and more on the medium to long term, both by funds themselves and by asset managers. Responsible ownership will play a huge role in ensuring this happens and should therefore be encouraged.

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?

To reduce investment fees
The investment management costs of the Nottinghamshire fund are already low, comprising only 0.18% of net assets in 2012/13. Simpler investment strategies inevitably mean lower fees:

- Managers feel far less able to charge high fees
- Trading costs may be lower
- Transition costs from one strategy to another will be lower

Collaboration between funds may act to reduce fees, although investment management is not ideally suited to framework agreements owing to the individual nature of investment mandates.

To improve the flexibility of investment strategies
Investment strategies designed to meet long term aims should not need to be changed regularly. If decision-making, monitoring and reporting focuses more on medium to long term performance, short term volatility can be weathered. Trends in performance can still be monitored to indicate problems with strategy or manager, allowing changes to be made where conditions have clearly altered.

To provide for greater investment in infrastructure
Whether to invest in infrastructure is a decision to be made on the basis of the valuation and the return requirements of each fund. An assumption that infrastructure is good for all funds is wrong. Regeneration is not a primary role of pension funds (although could have wider benefits to the fund if successful) and the risk/return profile of infrastructure investments must be considered.

To improve the cost effectiveness of administration
The key word here is ‘effectiveness’. The whole purpose of the fund is to meet pension payments. Ensuring contributions are received from employers and liaising with employers through difficult periods will potentially far outweigh the cost of additional resources to be able to do this effectively. Merging funds will not reduce the number of employers and larger, regional funds may find it harder to liaise with employers as they will be further removed from the communities in which they are based.

To provide access to higher quality staffing resources
To provide more in-house investment resource
It should be recognised that the LGPS already has access to high quality staff resources. However, examining the medium to long term benefits of closer liaison with employers and of in-house investment management will allow a proper assessment of the cost of providing additional high quality staff. The evidence of the benefits of in-house management should be discussed more widely.

Question 5 – What data is required in order to better assess the current 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?

There is a huge amount of data already in existence for the LGPS. All funds have to produce policy statements, accounts and annual reports and the latter are already provided by the majority of funds to CIPFA. All funds have to submit returns to CLG and the Office for National Statistics. The data should therefore be collated centrally and presented in one place.

Before considering creating regional funds (or any other form of merged fund) proper evidence should be collated to determine whether ‘bigger means better’ in terms of investment returns.

Analysis should also be carried out of the correlation of returns by manager to assess the risk of all funds underperforming at the same time. Having locally administered funds has the benefit of diversification of investment risk which may protect the LGPS as a whole compared to super-funds.

The new Scheme Advisory Board should play a key role in collating and analysing data in order to report openly about the advantages and disadvantages of any proposals for change.