London Pensions Fund Authority

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DCLG call for evidence on the future structure of the LGPS

LPFA's response

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Introduction to the London Pensions Fund Authority (LPFA)

The LPFA is a leader in the provision of pension administration for the Local Government Pension Scheme (LGPS). LPFA has its own pension fund with assets of over £4.6bn and also assists other local authorities and public sector organisations with all aspects of LGPS administration. Dedicated teams deliver the Fire Pension Scheme.

LPFA carries out third party pension administration and other LGPS services. Currently LPFA provides administration for Bexley Council, London Fire and Emergency Planning Authority (LFEPA), London Borough of Newham and Westminster City Council, Ealing Council, Hertfordshire County Council and Hertfordshire Fire Scheme. LPFA recently achieved re-accreditation in Information Security (ISO 27001) and Environmental Management (ISO 14001) and we have been honoured for our efforts in the governance field, winning a Best Trustee Training Initiative award from Engaged Investor.

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 purpose of the LGPS is to deliver good quality sustainable pensions to scheme members in accordance with the legislation and regulations and to have regard to overall efficiency and best value for money. Local accountability to taxpayers for historic scheme deficits can be achieved by linking deficits to employers through the triennial valuation process, as is currently the case with many multi-employer LGPS funds. There are a wide variety of employers involved with LGPS funds, not all whom are tax raising bodies. These include admission bodies, academies, higher and further education corporations and probation trusts, all of whom would remain responsible for any historic deficits associated with them under new arrangements. Many of these employers are funded directly or indirectly by central government who could ultimately be liable for any unrecovered deficit in the longer term. Smaller employers such as charities and those who are members of the scheme for historic reasons could also benefit from improved governance and expertise in all aspects of administering the scheme.

There is great merit in professional specialists directing scheme governance. In particular, a Board of representative interests is not the best model for pension fund governance. The LPFA believes the wider interests of the taxpayer are served by ensuring that investment decisions are made by appropriately qualified individuals in accordance with Myners Principle 1 "Effective Decision Making" as follows:

"Administering authorities should ensure that decisions are taken by persons or organisations with the skills, knowledge, advice and resources necessary to take them effectively and monitor their implementation; and

Those persons or organisations should have sufficient expertise to be able to evaluate and challenge the advice they receive, and manage conflicts of interest."

Such an approach would ensure that the participants in any pooled arrangement would be fully trained, fully qualified professionals. The Dutch central bank and many others have made this transition, and seen commensurate improvement in their net performance. This change would also offer the government and public demonstrable and understandable evidence of an improved governance opportunity within a super Pool, as long as there was also the highest level of transparency and accountability in the new arrangements

Our view, endorsed by a wide body of academic research, is that the most effective way to manage liabilities and generate superior investment returns is through consolidation of schemes into bigger entities. Our solution is to create Super Pools for the LGPS on a buy-in model, where local employers are responsible both for historic deficits and for holding the Super Pool manager to account, and the Super Pool is responsible for asset allocation, fund management (through internal talent/systems or appointment of external managers), liability management and administration.

The size of pooled funds will enable the highest levels of specialist expertise and advice to be available to all concerned. It will also ensure there will be full optimised expertise in all relevant areas which need to be taken into account to enable the most effective allocation of appropriate assets and investment strategy for the long term sustainability and affordability of the fund. Super Pools in the LGPS could, for example, be grouped by region into 5 such authorities with assets in the region of £30billion each, Alternatively if individual funds wished to group together on any other basis to enjoy the benefits associated with Super Pools they should be encouraged to do so. There is increasing evidence of funds already moving towards closer co-operation in all aspects of the Scheme, including full mergers, and legislation should be introduced to encourage and enable such a trend to continue.

Super Pools would allow for investment in best practice reporting and modelling. The introduction of regular Asset Liability Modelling (ALM) for all funds would allow for frequent and consistent reporting on deficits at any given point in time. Currently the liabilities of any LGPS fund are only valued once every three years at the valuation and decisions based on these figures.

Regular reporting and analysis of data will help ensure that a detailed and up to date understanding of liabilities and how these impact on the future investment strategy to be adopted will be available for those making key decisions. ALM will also help ensure that the highest standards of data quality are maintained on an on-going basis.

Data accuracy should be subject to regular review and analysis as part of any future governance arrangements. Super Pools should therefore be required to report on the quality of their fund data, in line with a defined and consistent basis to the National Scheme Advisory Board and internally to the new pensions boards and scheme employers, given its importance in helping to ensure the right investment decisions are made at the right time.

Any authority tasked with managing Super Pools will of course need to take account of the needs and concerns of the current administering authorities and other employers who participate in the fund, given they will continue in their role as guarantors of the funds and who would remain responsible for meeting historic deficits. Governance partners in the new arrangements must be able to influence the selection of those charged with governance, and have reserve powers to remove such appointees. This is to ensure that sufficient assurance is given to all authorities in a Super Pool and that they have a stake in the success of the new arrangements and that their interests should not be overridden. These authorities will also have a key role to play in ensuring a smooth and effective transition to Super Pools. What LPFA believe are the strong arguments for such an approach need to be clearly demonstrated and understood as part of any such process. Super Pools would have to continue to work closely with their partners to ensure full understanding of any investment decisions and changes to funding strategy and to provide clarity around how their own position is taken account of. There would also need to be a robust and transparent appointment process in place to ensure the appropriate body tasked with administering pooled funds would have access to the highest levels of expertise, coupled with an understanding of the needs of those on whose behalf they are working, and to whom they would ultimately be accountable to for overall performance. It would even be possible that authorities could consider removing themselves from any voluntary pooling arrangements if there were compelling reasons for doing so. Although the LPFA believes moving to Super Pool arrangements is ultimately the optimal position, it recognises the need for an evolutionary approach to this goal. The ultimate goal would be best delivered by the assent of willing partners and the demonstration of success to those more sceptical. The LPFA wishes to foster and participate in joint consensual arrangements as a means of evolving to a Super Pool. The LPFA would be happy to offers its services to Collective Investment Vehicles that are being developed.

Production and publication of high quality data on costs and income should be the statutory responsibility of the Scheme Board at national level and individual pools, to standards laid down and maintained by the appropriate professional bodies (CIPFA, etc.). At the present time, as commented on by Lord Hutton in his report on the Public Service Pensions Schemes, data on the LGPS are inconsistent and poorly maintained. There are significant and obvious disparities in the way such data are currently measured and reported, whether it is investment management charges, investment returns, administration costs or funding levels. The need for a common set of consistently measured data should be a key outcome of any review.

The SF3 figures are often quoted and used for comparison purposes when comparing investment or administration costs. However given there is no independent verification of the figures, and the evident disparities in the results, there is an urgent need for more consistent and accurate reporting. If the current figures are to be believed there are some Authorities who appear to be significantly more efficient in administering the scheme and whose examples should possibly be adopted by all, through closer co-operation or pooling of expertise. Alternatively, and more likely, the costs being reported are not on a like for like basis and a more meaningful and independent analysis of these costs will help highlight inconsistencies and define a more transparent basis for achieving proper comparison.

Comparison of investment management fees, as shown in the Communities and Local Government Department Local Government Pension Scheme SF3 data website are also fraught with difficulty and again there is no standard or commonly used definition of what should be incorporated in this number.

For investment management charges the only true comparison is the fund's investment performance net of fees against the fund's own benchmark. Each LGPS fund is likely to have a different benchmark, based on the different liabilities and age profiles of membership within the funds and therefore a straight comparison can be misleading.

Additionally the current definition of the fund management costs within the CLG data would mean that funds only return the total amount they are billed by fund managers. This hides fees that may not be disclosed directly but are netted off the valuation of pooled funds or funds in partnership structure. This might include investments in property pooled funds, bond funds, hedge funds, equity pooled funds and private equity and infrastructure limited partnership funds.

What is clear though and there are many examples in both the private and public pensions sector is that significant reductions in administrations costs can be achieved through consolidation and by making optimum use of available resources.

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?

High level objectives

1. Dealing with deficits

2. Improving investment returns

LPFA believes that these are the correct high level objectives of the review having proposed and spoken in favour of them at the roundtable with the Minister and at other seminars and discussions taking place.

LPFA believe that deficits should be assessed on both the "risk free" methodology (using current market assumptions on inflation and interest rates) as well as the actuarial basis (using assumptions on likely market returns from the fund's asset allocation to set contribution rates). Schemes which are below a threshold, say 40% on risk free assumptions or 70% on actuarial return assumptions, should immediately be put into special measures with decision taking on liability and investment management transferred to a suitable peer authority or new "public protection fund(PPF)". A formal review of funding levels on a consistent basis could take place immediately after receipt of the 2013 valuation results to take effect from 1 April 2014. Funds will currently be in the process of finalising their valuation results as at 31st March 2013 and will be available for an overall review in due course.

It is important, that as part of the on-going discussions around the sustainability and affordability of the LGPS that such an exercise is undertaken on a regular basis. There is otherwise a danger that there remain a number of funds where funding levels when measured on a consistent basis will fall below the thresholds detailed above and where urgent action and assistance may be required. There is a strong case for considering that any funds deemed to be below a specific funding level are placed in a PPF or responsibilities transferred to a similar body at the earliest opportunity.

In the medium term, following the creation of consolidated Super Pools, the pools should be responsible for producing recovery plans for each employer based upon, inter alia, the covenant of the employer in terms of its financial standing, tax raising powers etc.

LPFA believe that improving investment returns together with better liability management are the key reasons for structural change in the LGPS. Success against these objectives will be the achievement of the flight plan for investment returns measured on a quarterly basis. There is a wealth of academic evidence (e.g. from the Rotman Institute, Toronto) that demonstrates larger funds outperform smaller funds by up to 0.43%-0.50% per year. If this is translated to the LGPS, this is equivalent to increased investment returns of £750 million per annum. Given the current size of individual LGPS funds it would be hard to achieve such results for individual funds and nor would it be possible to justify the duplication of effort or associated costs of having the necessary staff and expertise in place at each authority, whereas a larger pooled fund would clearly benefit from the economies of scale associated with such an approach.

There is though some evidence available (e.g. the PwC report for the London LGPS funds) which indicates that some smaller funds have had relatively high investment returns over a number of years when compared to larger funds as a consequence of their specific investment strategy. However there is of course no guarantee that such returns will continue in the future and nor indeed that the right investment strategy has been adopted in respect of accrued liabilities. There is equally compelling evidence that the larger funds tend to outperform their smaller counterparts in all areas in the longer term, benefitting in addition from the lower management fees and increased in-house expertise larger funds enjoy. The recent report by JP Morgan on Australian fund consolidation also highlights many of the cost and operational advantages associated with larger funds.

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

There is a spectrum of reform options which LPFA believes set out the available range of options for moving forward and this is described below. As detailed above, our strong preference at this stage is that there should be a move towards Super Pools, thus ensuring

- the highest levels of specialist expertise will be available,
- that there is a larger investment pot to enable a diverse range of appropriate investment options to be considered
- That future strategy takes full and proper account of actual liabilities.

We also note that a range of options are currently being considered by other local authorities, such as framework agreements and Common Investment Vehicles, however, LPFA strongly believe that some of the real benefits which are needed will not be realised if such an approach is adopted in the longer term.

The real savings in management fees, the availability to access bespoke investment opportunities bringing higher returns and better liability management needs the backing of sufficiently large funds and associated expertise to succeed and therefore Super Pools are the only sustainable, longer term option.

We believe that in the longer term all those involved in the Scheme will benefit from such an approach, albeit there would be some loss of local control in terms of asset allocation and associated issues.

As mentioned previously however, local authorities will have a key monitoring role to play in ensuring the new arrangements are implemented and maintained effectively. Robust governance arrangements to provide assurance to all parties and the highest levels of transparency and accountability will be essential for the success of these new arrangements.

Spectrum of Reform Options for LGPS Pension Funds

Key Features and Responsibilities	Status Quo	Procurement Collaboration	CIVs	Super Pools (Buy-in)	Super Funds (Buy out)
Local pensions committee	Yes	Yes	Yes	Yes	No
Historic deficits	Local	Local	Local	Local	Central
Asset allocation	Local	Local	Local	Central	Central
Appointment of Fund Managers	Local	Local	Central	Central	Central
Liability management	Local	Local	Local	Central	Central
Administration	Local	Local	Local	Central	Central

Local means decisions taken at current administering authority or employer level`

Central means decisions taken at a new consolidated administering authority level

In summary the LPFA believe that the optimum structure should balance the objectives of local accountability (for historic deficits) and centralised administration, consolidated investment and liability management functions for efficiencies and economies of scale. The model described as Super Pools, with the attributes set out in the chart above would in the LPFA's view ultimately best meet the overarching objectives, as long as there were also robust governance arrangements in place. In the short term the best means of reaching this goal would be by building consensual arrangements amongst willing partners.

Going forward it may be possible to move to the Super Fund model, but considerable improvements in the area of deficit reduction would need to be achieved to make many LGPS schemes comfortable with this.

Super Pools could be grouped by region into funds of around £30 billion, although where there was a willingness by authorities to work closely together on achieving the benefits of Super Pools at the earliest opportunity there need not be any such geographical restrictions. It should be noted that three authorities in the South East have recently announced their intention to investigate a merger of their funds in order to increase their cost effectiveness by reducing costs, including fund managers' fees, and improving investment performance. Legislation that enables and encourages such movement by Authorities towards closer co-operation should therefore be introduced at the earliest opportunity.

Legal advice indicates that the Secretary of State would not need primary legislation to achieve Super Pools or LGPS fund mergers. Section 7 of the Superannuation Act 1972 (and Schedule 3(2) to that Act) contain wide powers for the Secretary of State to make regulations governing pensions for local government employees, and specifically a power to amalgamate funds. The process to be used is fairly similar to the process that has been followed on other local government reorganisations.

Regulation would though need to specify that going forward a particular authority would be the administering authority for the relevant pension funds and would then specify that they should be amalgamated or pooled into a single fund.

In order to achieve maximum efficiencies and impact any statutory instrument might therefore include:

- Power to pool LGPS funds

- Additional powers for authorities such as the LPFA to enter into shared service arrangements with other Authorities to expand the level of service provision and expertise available

- A specific set of circumstances to deal with failing LGPS funds – akin to the Pension Protection Fund

- A review of the LGPS Investment Regulations – with an opportunity to:
  a) deal with some of the issues that already exist under the 2009 Regulations (for example clarifying the extent to which LGPS funds may make use of derivatives);
  b) revisit the pooled fund's power of investment more generally (for example to allow a wider use of derivatives and for a wider use of discretionary investments);
  c) introduce the possibility to buy-out or otherwise discharge LGPS liabilities (for example with insurance companies) where opportunities arise.

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?

Secondary objectives

1. To reduce investment fees

2. To improve the flexibility of investment strategies

3. To provide for greater investment in infrastructure

4. To improve the cost effectiveness of administration

5. To provide access to higher quality staffing resources

6. To provide more in-house investment resource

The creation of Super Pools with centralised asset allocation, appointment of fund managers, liability management and administration would achieve all these objectives.

Investment Fees

The potential size of the Super Pools would give greater purchasing power over investment fees for which the industry model tends to be a lower fee percentage the higher the assets under management. Super Pools would also be able to afford in-house investment teams where evidence points to significant cost savings. The Rotman Institute research claims that half of the improved investment returns of larger funds come from the lower costs of in-house management.

Flexibility of Investment Strategies

The greater size of Super Pools will permit the recruitment of higher calibre investment professionals than smaller funds and a higher overall standard of governance. This will enable the use of complex hedging strategies to manage risk which are beyond the expertise of small schemes managed by lay people and enable flexibility in the implementation and management of investment strategies.

Greater Investment in Infrastructure

Super Pools will provide scale in terms of assets under management which enables direct or co-investments in infrastructure projects. These have the opportunity to generate superior returns over investment in funds or fund of funds with scale permitting the creation of diverse portfolios without the high fee leakages from funds or fund of funds. Infrastructure would prove to be a good match for the LGPS given that it provides not just a tangible asset for the fund but and can also support sustainable and socially responsible investment. Infrastructure has the potential to provide low-risk, long term investment opportunities with returns that are inflation-linked and match liabilities longer term on an optimised basis. Much interest is already being shown within the LGPS in such investments such as through the Pensions Infrastructure Plan, and the creation of Super Pools should help ensure the very best opportunities can be accessed and managed directly by individual funds in the future.

Cost effectiveness of administration

Good quality administration is required to ensure:

- High levels of customer satisfaction for fund members
- Good quality data from which to assess future liabilities
- Value for money for employers and taxpayers

Academic research shows that economies of scale flow from consolidating scheme administration. LPFA's experience as a third party provider to LGPS funds and Fire Authorities has delivered savings to Administering Authorities and has generated further surpluses to the LPFA as a provider to invest in further service improvement. Centralised administration has also ensured that high levels of technical expertise, specialist resources and the best systems are available, leading to improved data quality and efficiencies in processes and procedures. The marginal cost of administering the scheme in a Super Pool could be significantly reduced as duplication and inefficiencies are reduced. LPFA has also successfully worked with a number of authorities in improving data quality which has led to increased efficiency and a more accurate measurement of liabilities, allowing real savings to be achieved.

Evidence also suggests that a full local presence is not necessary to provide high standards of service to scheme members. For the LPFA the vast majority of contacts are by telephone and email coupled with comprehensive assistance and advice available through our bespoke websites for employers and scheme members. LPFA is approaching a level of 100% for notifications from its 200+ active employers being provided on-line, with the advantages in efficiency and accuracy this brings. We are also seeing a significant increase in the number of scheme members who are signing up to access our on-line member facilities to contact the LPFA, update personal details or review their records and calculate benefits payable.

Access to higher quality staffing resources

For the last 7 years, LPFA has employed in-house investment professionals to run the pension fund rather than rely purely upon external advisers, consultants or pension fund accountants as is the case with many smaller LGPS funds. At LPFA the Chief Investment Officer operates as a "manager of managers" responsible for developing investment strategy, liability management, selecting and appointing fund managers and monitoring their performance. Many smaller funds claim that they are unable to afford the costs of a dedicated CIO role with appropriate levels of professional support. It follows therefore that aggregation of funds into even larger Super Pools would facilitate access to higher quality staffing resources.

Academic research shows that when investing in alternative asset classes such as infrastructure, property or private equity, scale is critical to achieving super normal returns. Scale enables funds to invest directly or co-invest rather than only have the option of investing through funds or fund of funds with their associated high fee charges.

More in-house investment resource

Academic research shows that nearly half the additional returns generated by large funds over small funds come from the ability to utilise in-house managers rather than rely purely upon external fund managers. Research by the Boston Consulting Group on the Canadian public pension plans, where 80% of assets are managed internally, shows that fund management costs average 0.30% compared to 1.50%-2.50% for many other funds.

Again the ability to attract and retain in-house investment teams requires scale and hence would be an attractive option for Super Pools. It would not be possible to make such resources available to all 89 funds and in any event the costs of doing so on a much smaller scale would be prohibitive.

Recent research from Oxford University's Said Business School has highlighted the importance of ensuring Scheme managers make educated and informed choices around their fund manager's, rather than relying solely on a particular manager's recommendation. This report again demonstrates the need for strong, well trained and informed investment resources being available in-house to the funds themselves to ensure the correct choices are made.

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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?

In order to gauge the potential impact of a radical restructuring of LGPS funds, it is necessary to look beyond the UK to the success stories of pension arrangements in areas such as Canada and compare the results to the LGPS in England and Wales. There is a wealth of data from Northern Europe, North America, South America and Australia which support the underlying principle that the size of a fund coupled with significant levels of in-house specialist advice and expertise lead to higher investment returns and a better understanding of overall funding and liability issues. Please see the case studies attached that support this analysis.

For the LGPS in England and Wales there is a dearth of good quality data. LPFA's suggestions for improving the collection and interpretation of data are set out below:

- Administration and fund management costs:

  Existing SF3 data is not prepared to any agreed standards so comparison is fraught with difficulties and simplistic conclusions prevail. Administration costs need to be standardised by a suitably qualified independent body such as CIPFA, in agreement with the NSAB so that there are common practices on items charged to Administration, the Fund or Councils' general funds. Such reporting will help identify those areas of genuine best practice and efficiency and ensure they can be enjoyed by all involved in the scheme.

  Fund management costs need to include costs which are charged against the Net Asset Value of pooled funds and are generally lost in the SF3 returns. Fund management costs also need to differentiate between base fees and performance fees so that comparisons recognise that higher fees can generate higher returns if managers are suitably incentivised. Again CIPFA could play a key role in ensuring common definitions and appropriate comparisons.

  The significant discrepancies between the highest and lowest cost per member figures from SF3 returns in both administration and investment terms are so large as to make any comparison on this basis meaningless. However an independent and consistent analysis to identify where there are real differences and the ability to clarify and share genuine areas of best practice and efficiency as a result, would benefit all involved in the scheme.

- Investment performance

  Many LGPS funds have tailored benchmarks reflecting their maturity profiles and appetite for risk. Not all funds are the same and a simplistic comparison of one fund's performance against another, or a peer group benchmark, is comparing apples with pears. Therefore performance comparisons need to be more sophisticated and again this should be a task for CIPFA in association with the NSAB, to take on working with the financial services industry and existing performance management service providers.

Take a simple example. If fund A had £100 million and was invested solely in a passive UK equity index tracker, it might attract a fee of say 0.1%, or £100,000.

Suppose fund B of the same size was invested in an actively managed UK equity fund and targeted a return of 2% above the UK index benchmark. It might pay a fee of 0.2% or £200,000. If the manager was successful in meeting the target, the fund would achieve a net return of £1.8 million over the index benchmark (£2m investment return less £200,000 fees). Although fund B had paid twice the fees, its return overall is significantly better.

Suppose fund C of the same size was invested in an actively managed UK equity fund and targeted a return of 2% above the UK index benchmark, but was prepared to incentivise the manager to outperform the target. It might pay a base fee of 0.15 % or £150,000 plus 10% of any excess return over 2%. If the manager was successful in achieving a return of 2% over the target (4% over the index), the fund would achieve a net return of £3.65 million (£4m investment return less £150,000 base fees, less £200,000 performance fees). Although fund C had paid far more in fees than either fund A or fund B, its return overall is significantly better.

These examples are indicative, but they provide a general picture of the difficulties in measuring costs and performance on a consistent basis. The only true comparison therefore is the fund's investment performance net of fees against the fund's own benchmark. To make it even more difficult to compare performance, each LGPS fund is likely to have a different benchmark, given the different liabilities and age profiles of membership within the funds.