UBS

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For professional clients only

Call for evidence on the future structure of the Local Government Pension Scheme: *UBS Global Asset Management Response*

Local Government Pension Schemes (LGPS) have always been an important and valued group of clients at UBS Global Asset Management. We have a long history of managing assets on behalf of UK Local Authorities, with some relationships dating back to the 1950s. We are currently one of the largest active managers of local authority assets and we manage mandates on behalf of almost 30 UK Local Authorities. Our experience over half a century has enabled us to develop a deep understanding of the issues faced by LGPS and the role the asset management community can play in addressing these issues.

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 – adapting to become more efficient and to promote stronger investment performance.

As an investment manager we are not best positioned to provide an answer to this question.

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?

We wholeheartedly agree that Scheme deficits, and the role that improving investment returns has to play in repairing these deficits, should sit at the epicentre of determining the direction of travel for LGPS.

However, in considering the issue of Scheme deficits, we question the direct benefit that a radical solution, such as Scheme mergers, would have on repairing deficit positions. Rather, we firmly believe it is important to look to history in order to properly understand how Scheme deficits have evolved, and to understand the problem beyond simple structural issues. There are a host of demographic, historical and structural factors which need to be considered.

The overarching point to be made is that however good investment returns could be in the future, they are unlikely to repair Scheme deficits on their own. Of equal importance are factors like:

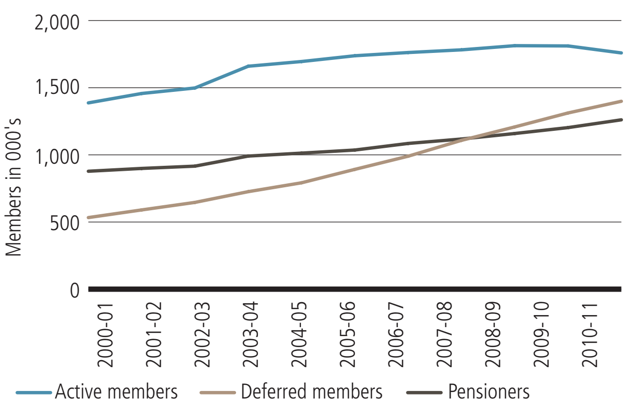
- Employer and employee contribution rates
- Benefit levels
- Discount rates
- Longevity

The 1980's and early 1990's saw a period of underfunding in LGPS, with employer contributions at very low levels and some Schemes even taking employer contribution holidays. A further contributing factor to current deficits is a political one. Between 1990 and 1993, the Government at the time encouraged LGPS to fund only to a level of 75% in an effort to dampen local tax rates. This effectively allowed pension Scheme members to accrue benefits without the requisite contributions being made in order to meet these liabilities[1]. Scheme deficits are now measured versus a 100% funding position, meaning that the long term structural impact of such low contribution rates is now being keenly felt.

A lesson to be learnt perhaps, and not be repeated?

Austerity has a further, significant part to play in Scheme health. The Office for Budget Responsibility 2012 report estimated that the public sector workforce will shrink by 710,000 by 2017. This would effectively take the size of the state sector to its lowest level since the creation of the welfare state after the Second World War, and is a direct result of redundancy programmes, outsourcing agreements and early retirement provisions. This, of course has the direct consequence of reducing employee contribution levels in pound and pence terms, whilst increasing the immediate liability burden to pay for those early retirees.

Chart 1: LGPS membership profile (2001 – 2011)

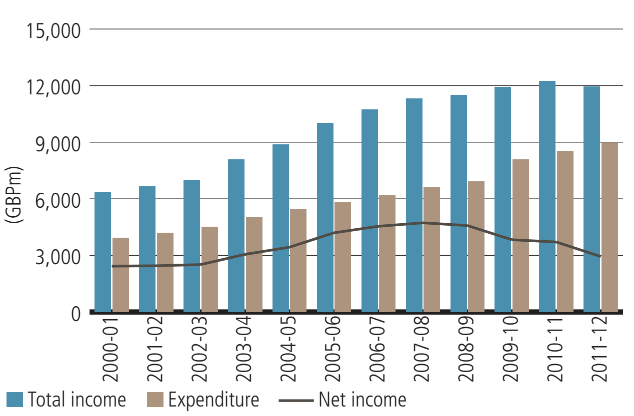


Source: Local Government Chronicle, 24 November 2011

This is even further exacerbated by active members, who in the current economic situation, are choosing to reduce their monthly pension contributions in an attempt to protect a standard of living[2].

The effect on the financial strength of LGPS is dramatic. Employee contributions peaked in 2009-10 at GBP 2bn but then fell back in 2010-11. The Chartered Institute for Public Finance and Accounting estimate a 20% drop in employee contributions over the past two years.

Chart 2: LGPS net cash flow (2000-01 – 2010-11)



Source: Local Government Chronicle, 24 November 2011

[1] New Local Government Network, Room-to-Manoeuvre, Dr David Chapman and Tom Symons, 2010

[2] The Chartered Institute for Personnel and Development, 2012

This is a stark reminder that employee, as well as employer, contribution rates have a key role to play in Scheme health and cannot be viewed in isolation of each other.

These monetary constraints are further compounded by the increasing life-expectancy of the UK workforce. The UK has witnessed a dramatic rise in life expectancy, having increased from 75.7 years in 1990 to 79.9 years in 2010[3]. Clearly this should be viewed as good news, however, in the context of a pension Scheme it is estimated that for each extra year of life expectancy for retirees, the Scheme must increase its assets by between 3% and 4% in order to offset the increased liability[4].

Recent investment performance of LGPS has also come under further scrutiny as the financial crisis of 2008 created significant market headwinds for risk assets, and periods of rarely seen volatility in which bond yields have plunged. In the five year period ended December 2012, LGPS underperformed the long-term return target assumed on their assets on average by 2.8%[5]. A not insignificant number, which will have a strong bearing on the outcome of Scheme valuations and deficit levels. Furthermore, LGPS on average underperformed their corporate pension peers by 0.8% over the same period[6]. However, this last statistic in isolation does not substantiate anything and demonstrates the danger of making broad conclusions based on a single data point. Due to the difference in liability profiles between LGPS and corporate Schemes, a higher bond allocation is typical within a corporate Scheme versus LGPS. Bonds have performed particularly strongly in recent years leading many commentators to speculate on the existence of a 'bond bubble'. Notwithstanding the significant losses in equity markets during 2008-09, the longer term performance of equities has indeed been beneficial to LGPS in general due to historically high allocations. It needs to be stressed that the overall asset allocation dominates Scheme performance, rather than the choice of an active versus passive management strategy or the selection of a specific manager. Performance also needs to be measured in the context of how much risk is taken and how the risk budget is managed.

In summary, there are a host of factors which have contributed to the current funding position of Schemes. UBS Global Asset Management would urge that ALL of these factors are considered when determining the next steps for LGPS. It would be a mistake not to take heed of the lessons of the past, not to remember the extraordinary market conditions of recent years and thereby "throw the baby out with the bathwater".

The most obvious measure of success would be for LGPS to move towards a fully funded state, underpinned by economic tailwinds, settled market conditions, strong investment performance and palatable employer and employee contribution rates. If this were wholly achievable then there would be no requirement for such a Call for Evidence to exist.

So what should a realistic measure of success look like? Defined Benefit Schemes in the corporate sector carrying a deficit must have a recovery plan in place which is submitted to the Pensions Regulator for review. The stated aim of this recovery plan is to close a Scheme deficit as quickly as possible within the constraints of employer affordability. Typically, any recovery plan which extends beyond ten years is subject to an extra layer of scrutiny from the Regulator.

Such a prescriptive approach does not exist within LGPS. Should it?

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

There are a wide range of options for reform being openly discussed, ranging from mass Scheme mergers to the creation of Collective Investment Vehicles. The options being discussed each have their unique merits and weak points. As a member of the asset management community, UBS Global Asset Management recognises that change from the current status quo will have a direct bearing on our business and, as such, it is difficult to answer such a question without being accused of protecting our own interests.

However, there are two broad observations we can make that need little interpretation. Firstly, we see little or no correlation between the size of a Scheme and its overall investment performance; and secondly we highlight that transition costs to a new arrangement can often be many times larger than potential savings on fees in the short to medium term. Transition costs are naturally variable, however, to contextualise the point, we recently carried out a transition on behalf of a client moving between two global equity strategies at a cost of circa 20 basis points.

One area of potential reform which has received limited coverage to date, is in respect of the governance structure of LGPS, and the role good governance has to play in best meeting the high level objectives.

The LGPS governance structure is severely tested at every election cycle, at times leading to significant turnover of Investment Committees. This presents a plethora of challenges for Schemes, not least the loss of continuity and investment expertise, as well as the stresses placed on the decision making process. The current situation gives a very clear example of the challenges faced by new members of Investment Committees following the elections of May 2013:

- Limited investment experience within certain Investment Committees
- An immediate need for investment and skills and knowledge training
- An actuarial valuation to understand and interpret
- A strategic asset allocation review to consider and ratify in light of the actuarial valuation
- The Government led debate about Scheme structures and the subsequent Call for Evidence.

[3] The Lancet, December 2012
[4] BBC News, November 2010
[5] WM Group Universe Results
[6] WM Local Authority Quarterly Review, Q4 2012

These are a daunting set of challenges for an experienced Investment Committee, let alone a Committee which has undergone significant change in recent months. The consequence of this is that for a number of Schemes the pressures placed upon the Pensions Officers are increasing further, at a time when Pension and Treasury departments are faced with considerable resource and time constraints.

The role of local accountability is at the heart of LGPS and it is important that this remains, not least because of the influence that employer pension contributions have on local council tax levels.

However, UBS Global Asset Management is of the view that the creation of a permanent professional Investment Committee has a role to play within LGPS.

The structure envisaged is that elected members retain ultimate accountability and are responsible for the formulation of long term Scheme strategy with the focused aim of meeting the high level objectives proposed in the Call for Evidence. In the context of the Public Service Pensions Act 2013, elected members would assume the role of a "pensions board".

The important difference from the current structure is the proposal that Investment Committees are made up of professional investors, a majority of Pension Officers and advisors, with elected members having minority representation. The Committee would then have the delegated authority for the implementation and day-to-day monitoring of the long term Scheme strategy, with decisions such as manager appointments residing with the professional Investment Committee, rather than with elected members as is the case today. In essence, such a Committee would assume the role of "Scheme manager".

The advent of a professional Investment Committee should help facilitate efficient portfolio construction and asset allocation through a streamlined decision making process. Whilst LGPS cannot influence fund manager performance, efficiency of investment decision and execution has a key role to play in achieving a Scheme's long term strategy in a risk controlled manner.

The Investment Committee ("Scheme manager") would be accountable to elected members ("Scheme board"), with the measure of success being how the Committee's decisions have contributed to the long term strategy as formulated by elected members.

Conceptually, this could be implemented on a Scheme by Scheme basis, across a framework of Schemes, or regionally.

A second area that we believe should be considered is the onerous Official Journal of the European Union (OJEU) procurement rules. Whilst reform of this buying process may not be possible in the medium term, UBS Global Asset Management deems it to be worth highlighting the influence that the procurement process can have on LGPS versus corporate Schemes that are not subject to such rules. The table above is a sample of recent procurement activity

Table 1 – Sample of LGPS Procurement Timelines

Scheme name	Search release date on OJEU	Appt /OJEU publication date
Scheme A	09/05/2012	14/01/2013
Scheme B	09/03/2012	10/04/2013
Scheme C	21/02/2013	29/07/2013
Scheme D	16/10/2012	13/03/2013
Scheme E	01/08/2011	13/06/2012
Scheme F	08/07/2012	20/02/2013
Scheme G	13/07/2012	20/09/2012

Source: OJEU – Tenders Electronic Daily. For illustrative purposes only

across seven different LGPS and public agency Schemes. The interesting point to note is the range of timelines involved, stretching from twelve months through to a highly aggressive two month procurement process.

Whilst specific timelines are harder to evidence with corporate Schemes due to the lack of publicly available information, our experience as an asset manager tells us that typically manager searches are less protracted. A larger proportion of corporate Scheme searches are completed within a 2-3 month timeframe and it is rare for searches to extend beyond six months.

The point to note is that LGPS does not share the same ability as corporate Schemes to move quickly in the execution of investment decisions, which can have a direct impact on Scheme performance depending on the prevailing market conditions at the time.

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?

1. Investment fees
Compared to the impact of Scheme governance and asset allocation on the future solvency position of any pension fund, saving a finite number of basis points on manager fees will not on its own turn-around the future financial health of a pension Scheme. It will certainly help, but not to the extent that is being discussed in the press to date. For equity and bond assets, focus should rightly remain on whether the significantly higher fees paid for active management are justified by the results. Schemes should also remain aware that accessing more specialist alternative strategies will likely come at a higher price, particularly in a fund of fund structure. Price should not be a reason to walk away from an investment opportunity, and each investment opportunity must be reviewed in the context of its investment characteristics versus the long term Scheme strategy, with price being a consideration rather than a driver of decisions.

It should also be highlighted that a wholesale reform of LGPS may also herald several unintended consequences. Asset managers such as UBS have LGPS at the heart of their business, however, it is fair to say that for a number of our peers, LGPS is not a core pillar of their asset management activity. Should the number of Schemes reduce or the number of mandates available for tender reduce, through framework agreements for example, UBS fears that the breadth and depth of managers focusing on LGPS may also reduce. For those managers where LGPS is not a core pillar, the risk is that the opportunity cost of marketing to LGPS is deemed to be too great, with budget and focus diverted elsewhere.

This may, over the medium term, reduce competition amongst managers and thereby remove the pressure on managers to reduce fees.

However, the creation of a professional Investment Committee may help realise fee savings in several ways:

i. Continuing and expanding initiatives such as joint procurement and framework agreements. These can utilise economies of scale to procure investment services from investment managers which can help drive down costs.

ii. Forging long-term relationships with asset managers to achieve value for money. Many larger multi-product Investment Managers boast an array of tools and expertise which can be of particular benefit to LGPS. These tools may include market intelligence, economic insights and trustee training. This not only improves Scheme governance but better equips members with the ability to determine and monitor the long term direction of individual Schemes. UBS Global Asset Management would urge that manager fees are viewed in the round, taking into consideration all that an asset manager has to offer, not just the management of a specific mandate.

2. To improve the flexibility of investment strategies
As noted earlier, there is a medium term risk that wholesale structural reform of LGPS may reduce the range of asset managers available to the sector. A further point to consider is the role of alternative asset classes within LGPS, and how the size of mandate awards can have an impact on LGPS' ability to achieve their desired outcome. Capacity constraints of asset managers and specific strategies should be a key consideration when allocating assets. Finite capacity can result in LGPS being unable to fully access a strategy due to the larger pool of assets which may exist as a consequence of wholesale structural reform. Equally, where capacity constraints exist, it is highly unlikely that LGPS will be able to negotiate a meaningful fee discount. This is particularly true where the chosen strategy has global appeal and is not specific to UK pension Schemes, In these circumstances, LGPS will be competing with Schemes from elsewhere in the world, meaning that managers will likely choose to fill capacity with full fee paying clients.

A professional Investment Committee will, however, have the ability to play an integral role in strategic and tactical discussions and should help in improving the flexibility of investment strategies:

i. Streamlined decision making processes

ii. The permanence of the Investment Committee should improve the ability of LGPS to forge long term partnerships with asset managers, allowing this professional body to extract value-added services from managers

iii. Both these factors should then result in more efficient implementation and a more dynamic asset allocation.

3. To provide greater investment in infrastructure
The options for reform outlined in this paper will not directly result in greater investment in infrastructure. Rather, they will allow greater investment expertise and informed decision making. This equips LGPS to better assess the investment case for infrastructure alongside other asset classes and how any resulting investment should be realised. Any investment into infrastructure should be made on the basis of its investment characteristics and risks and how these combine to achieve the high level objectives of dealing with deficits and improving investment returns.

4. To improve the cost effectiveness of administration
As an asset manager we are not well positioned to provide an answer to this question.

5. To provide access to higher quality staffing resources
As an asset manager we are not well positioned to provide an answer to this question.

6. To provide more in-house investment resource.
A permanent professional Investment Committee will supply on-going in-house expertise. Given the varied funding ratios of LGPS and the local demographic and social factors affecting the deficit, detailed investment understanding and continuity is critical. Furthermore this also allows Elected Members to focus on the strategic direction of the Scheme without being required to opine on the minutia of day-to-day Scheme management.

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 options proposed under this call for evidence? How could such data be best produced, collated and analysed?

As an asset manager we are not well positioned to provide an answer to this question.

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