



**WELSH LOCAL GOVERNMENT PENSION FUNDS**

**WORKING TOGETHER**  
**(INTERIM REPORT)**

**MARCH 2013**  
(Version 6.1.1)

**Society of Welsh Treasurers Pension Sub Group**

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# EXECUTIVE SUMMARY

## Background

The Local Government Pension Scheme in Wales has over 280,000 members and has assets valued in excess of £9bn. In March 2010, the Pensions Sub Group of the Society of Welsh Treasurers representing the 8 LGPS funds in Wales commissioned a study by Price Waterhouse Coopers (PwC). The aim was to build on the existing collaboration already undertaken in Wales and identify the potential for collaboration/partnership working across the Welsh Local Government Pension Schemes.

The PwC study provided a base upon which some broad assumptions could be made i.e. that the whole issue was worthy of further consideration. The work has been taken forward by the SWT Pensions Sub Group with appropriate support. They believed **the PwC report was important in that it established a "prima facie" case to look further at the organisational structure of the Welsh LGPS with the potential to improve efficiency and service standards.** It was recognised and important from the outset that any further work was objective and positive in working toward the production of an evidence backed outline business case. Due regard would be given to work undertaken elsewhere, which could helpfully assist in this process, but conclusions drawn elsewhere would not drive the conclusions of this report.

## Objectives and Methodology

The purpose of this report is to set out the findings of the outline business case which has considered the optimal number of LGPS funds in Wales and the most appropriate organisational structure. This should also include proposals for enhanced collaboration, including, joint procurement opportunities and other efficiency measures.

In undertaking the work, and in order to keep the task to manageable proportions, the Project Board determined that analysis should be focussed around four options;

1. An "as is" option based on the current structure with 8 Funds which provides a benchmark position.
2. An "as is" but with enhanced collaboration (Joint procurement, shared working efficiencies etc.)
3. A mid range option based on a number of grouped Funds. The requirement is to provide the solution that works best and so at the outset, the project was not prescriptive regarding numbers and groupings which could be seen as limiting the options for consideration.
4. An option based on one all Wales LGPS Fund.

**There was no presumption that the optimum solution for one work stream (e.g. administration) would also be the best for another (e.g. investments).** The approach was therefore to be totally objective and open minded and ensure analysis was objective and robust to withstand scrutiny and challenge.

The Board adopted a collaborative approach utilising the resources across all 8 Funds and the expertise of the in-house teams. Work stream groups were established covering Administration, Investments and Funding, and Financial Modelling. The latter also covered the subject of governance. Research was undertaken in all areas commissioning a number of external reports in respect of investment performance,

legal issues, funding and investments and transition costs. There was a need to co-ordinate the research work produced by the work streams. To this end, it was considered appropriate to provide a non prescriptive outline of what could be included within each work stream's plans. The research work of each work stream therefore included but was not be restricted to:

- A review of the PWC Report and use of that report as the starting point, subject to appropriate validation if, and where required;
- Updating and validation of core data
- Consideration of the 4 options, including implications relating to governance and transition, and objective justification for those discarded and those worthy of consideration.
- Consideration of the service delivery options
- Consideration of key components -e.g. service delivery and standards, people, IT, accommodation etc...
- Pros and Cons of different options
- Barriers to change or implementation
- Assessment of options against agreed design principles
- Conclusions
- Recommendations

Although originally included, the following have been held back in this interim report but will be incorporated in the final version.

- Views of wider stakeholders
- Views on timing of any proposed changes

The design principles adopted below were generic rather than specific to Pensions but the principles were sound and formed a backcloth to the work to be undertaken by each work stream. These principles also acted as a "litmus test" of the appropriateness of the proposals put forward.

- Reducing costs and sustaining service
- Improving front line service delivery
- Delivering a timely and responsive service
- Improving back office administrative consistency and efficiency of process
- Achieving the most by appropriate collaboration
- Improving the employee/pensioner experience
- Comply with sound governance arrangements and stewardship controls.
- Better information for better decisions

## **Findings of Investment Work**

1. **There is evidence that there are potentially significant financial benefits of scale to be found** from either merger or working collectively through a common investment approach. The results of analysis demonstrate a general statistical trend of higher investment returns when a larger amount of investment assets is grouped together and invested. There are however no

guarantees of improved returns and **it does not appear to require organisational change to benefit since enhanced collaboration would achieve the same goal in a quicker and less disruptive way.**

2. **The potential benefits are not a direct relationship with the size of a fund but rather the result of economies of scale that together with size allow improved governance and the potential for increased return with a combination of attributes that larger funds tend to have** such as
  - More internal / specialist resources;
  - More internal / hands on management;
  - Better diversification – asset classes, managers;
  - More bargaining power on fees;
  - Better, more responsive governance structures and processes in place enabling speedy decision making.
3. Changes introduced as a result of the findings of this paper would not impact on employer contribution rates until the Actuarial Valuation after any changes were implemented (i.e. **earliest impact could be 2017/18**).
4. It is impossible to predict future investment returns with any degree of certainty.
5. The variety of valid funding assumptions and approaches adopted across Welsh LGPS funds makes comparison difficult and has the potential to significantly cloud the interpretation of a Funds funding position.
6. Given other influencing factors at this time such as changing (increasing) liabilities, changing membership profile, improving longevity and benefit design changes, **the impact of any investment benefits are more likely to be a dampening effect on future upward contribution pressures resulting in slower growth in the employer contribution rates rather than a reduction.**
7. There are inherent difficulties in adopting a common investment/funding strategy across all Funds whilst they remain independent legal entities. **The more appropriate option would be a common approach to the implementation of a Funds strategy rather than the Strategy itself being common.**
8. Funding changes are the most complex and lengthy areas for change but also have the greatest potential for cost saving.
9. Investment manager fees amount to some £22.3m per year across LGPS funds in Wales. A common investment approach could provide some modest savings which even if a low level of only 10% saving were achieved would amount to a £2m saving across Wales; equivalent to 0.1% on employer contribution levels. It is important to note however that to deliver such savings would potentially incur significant transition costs at the outset.
10. On the basis of the evidence, there is, from an investment standpoint, **a prima facie case for change and an appropriate programme of works should be put in place** to maximise the benefit which can be realised through greater collaboration, including specifically managing Pension Fund Investment assets on a collective basis.

## **Findings of Governance Work**

11. **There is much that can be done using a collaborative approach within existing legal, organisational and governance arrangements.**

12. Merger cannot be undertaken without a change in secondary legislation at UK level. This would be the most challenging option with the longest lead in time, requiring engagement with both Wales Government and the DCLG.
13. Merger would distance Funds from local accountability and control unless additional layers of governance were introduced.
14. A common investment proposition is feasible within the existing investment regulation framework but clarification on aspects of the Regulations from DCLG would be helpful.
15. A Governance structure to develop and control future collaboration across Wales needs to be established with agreed standards.

### **Findings of Administration Work**

16. **Building on existing collaboration and the additional impetus provided by this Collaboration project, can achieve improvements in front line pensions service delivery**, consistency and efficiency whilst ensuring compliance with sound governance arrangements and stewardship controls and regulations.
17. A local presence is important for responsive service delivery.
18. The absence of agreed service standards within the LGPS does not help meaningful comparison either within Wales or across UK funds.
19. Administration costs across the LGPS Funds in Wales amount to some £8m per year. **Financial benefits identified through the administration work are thus far more modest than those identified elsewhere but should nevertheless be pursued.**

### **Findings of Costs and Transition Work**

20. **Both fund management fees and transition costs are significant factors** but not the fundamental drivers when considering investment strategy.
21. Merger to one Fund or the mechanism of a collective investment vehicle would facilitate potentially lower management fees, but the overall reduction in fees (if indeed achieved) as a percentage of market value across Wales would be dependent on the new investment strategy and the method of implementation.
22. **There would be very significant 'one off' costs of transitioning the assets to a new organisational structure.**
23. An attempt has been made to quantify the fee reduction and cost of transition but these should be used for illustrative purposes only as the assumptions are many. In isolation, and prior to factoring in any improved investment return due to size and associated attributes, it is reasonable to conclude that transition costs will be significantly higher than any potential reduction in management fees and thus it could several years to 'pay back' the cost of transition before any lower fund management fee benefits accrued.

## Conclusions

It is clear that there is no simple and quick solution that answers the question; what is the optimal number of LGPS funds in Wales and the most appropriate organisational structure. Given the existing organisational picture, and the funding complexities, any change will require careful planning and will take time to implement/achieve. The work undertaken however clearly indicates that despite collaboration already being part of the Welsh fabric for pensions, the “no change” option is not supported since a more pro-active approach to consistency and service efficiency is required.

Enhanced collaboration is seen as the area where medium term savings can be optimised. This is the option where the balance of service delivery and efficiency, cost of change, time and resource can be blended in the most effective way and should be pursued further. This should include proposals for enhanced collaboration, including, joint procurement opportunities and other efficiency measures.

Analysis demonstrates that the potential financial benefit through any change varies considerably with the smallest benefit in the administration area and increasing in size through joint procurement, combining investments to benefit the level of fund manager fees and larger investment mandates (via merger or a collective investment vehicle) potentially achieving better investment returns. This latter option could however be achieved in a less disruptive manner through a collective investment vehicle across existing structures as opposed to new and larger structures.

The prospect of merger to regional funds or a single Welsh Fund is both complex and the transition would be costly with a long lead in time and a loss of local autonomy. Changing funding strategies could also have a destabilizing effect with a loss of local accountability. Following any merger of funds a common set of actuarial assumptions would also be needed for future valuations of the merged fund. This would have an impact on employer contributions. Whilst this may merit additional investigation in the right environment, it is not recommended for further work at this time.

## Key Recommendations

1. **The “as is” or no change option is not supported.** The pension's environment requires a more pro-active approach to managing service standards and costs within the LGPS within Wales.
2. **Enhanced collaboration is seen as the area where medium term savings can be optimised. This is the option where the balance of service delivery and efficiency, cost of change, time and resource can be blended in the most effective way and should be pursued further.**
3. **To create a Full Business Case for a common investment approach** to encompass the common attributes that appear to benefit larger funds with the aim of implementation thereafter.
4. **To create an appropriate and responsive governance structure to drive and manage future collaboration initiatives within Wales** which will:
  - a. explore the potential in the longer term for consistent Valuation and funding assumptions and standards.
  - b. develop minimum administrative service standards for Wales and an agreed measurement framework.
  - c. take advantage of joint procurement initiatives to help consistency and efficiencies
5. The prospect of **merger to regional funds or a single Welsh Fund is both complex and the transition would be costly with a long lead- in time and a**

**loss of local autonomy.** Changing funding strategies could also have a destabilizing effect with a loss of local accountability. Whilst **this may merit additional investigation in the future, it is not recommended for further work at this time, especially where it is believed that the most significant gains can be realised through greater collaboration and, specifically a common investment approach.**



## Background and Context

### Background

In March 2010, the Pensions Sub Group of the Society of Welsh Treasurers representing the 8 LGPS funds in Wales commissioned a study by Price Waterhouse Coopers (PwC)<sup>1</sup>. The aim was to build on the existing collaboration already undertaken in Wales and identify the potential for collaboration/partnership working across the Welsh Local Government Pension Schemes.

The initial study concluded that there was scope to generate further efficiency savings along with achieving greater consistency in service standards across both the administration and investment arms of fund management, suggesting that such benefits would be optimised through either further collaboration or a reduction in the number of funds. The savings provisionally identified could well be seen as small in the context of the combined assets of the 8 pensions funds (£8.5bn plus at that time) but they were considered large enough to merit further investigative work. The study also recognised that all Funds had very different approaches and changes, whether at an organisational level or restricted to either Investments or Administration would be complex and would take time to achieve. Transition would also be complex and would incur costs with payback periods varying according to the degree of change. In addition, because contribution costs for employers in the respective funds are generally only amended every three years (at the triennial valuation), the earliest financial year when such savings might be identified, from even very prompt actions, would be linked to the actuarial valuation cycle.

Governance arrangements were also identified as a significant issue in the context of any further work to be carried out.

The PwC study however provided a base upon which some broad assumptions could be made i.e. that the whole issue was worthy of further consideration. The Pensions Sub Group of the Society of Welsh Treasurers acting as a Project Board agreed for more detailed work to be undertaken to produce an outline business case around proposals for a possible reduction in the number of Welsh Pension Funds, and/or the possibility of further collaboration including joint procurement opportunities and other efficiency measures. The Project Board commitment was evidenced by the fact that the Project pre-dated but was then endorsed by its inclusion in the Compact between the Welsh Government and Local Government (signed off at Partnership Council on 5 December 2011).

The work has been taken forward by the SWT Pensions Sub Group with appropriate support. They believed the PwC report was important in that it established a "prima facie" case to look further at the organisational structure of the Welsh LGPS with the potential to improve efficiency and service standards. It was recognised and important from the outset that any further work would be objective and positive in working toward the production of an evidence backed outline business case. Due regard would be given to work undertaken elsewhere, which could helpfully assist in this process, but conclusions drawn elsewhere would not drive the conclusions drawn here.

The purpose of this report is to determine via an outline business case, the optimal

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<sup>1</sup> **Price Waterhouse Coopers; Consultancy review of Welsh Local Government Pension Funds October 2010**

number of LGPS funds in Wales and the most appropriate organisational structure. This should also include proposals for enhanced collaboration, including: joint procurement opportunities and other efficiency measures.

## Scope

The initial study by PwC provided a level of confidence that proceeding to an outline business case was appropriate. Some concerns had been raised about the results produced and there had been some feedback that the initial work had not been sufficiently clear on the impact of any possible change on each pension fund. There were also reservations expressed with regard to the validity of some of the data comparisons. The ability to address these concerns and ensure a high level of engagement during the next stage was therefore of key importance.

In undertaking the next stage of work, and in order to keep the task to manageable proportions, the Project Board determined that analysis should be focussed around four options; two polar views and two mid range options with one based on enhanced collaboration and one based on a reduced number of funds. These options are:

1. An "as is" option based on the current structure with 8 Funds which provides a benchmark position
2. An "as is" but with enhanced collaboration (Joint procurement, shared working efficiencies etc.)
3. A mid range option based on a number of grouped Funds. The requirement is to provide the solution that works best and so the Project Initiation Document (PID) was not prescriptive regarding numbers and groupings which could be seen as limiting the options for consideration.
4. An option based on one all Wales LGPS Fund.

There was no presumption that what was optimum for one work stream (e.g. administration) would also be the best solution for another (e.g. investments). The approach was therefore a "blank piece of paper" approach aiming to be totally objective and open minded and ensure analysis was objective and robust to withstand scrutiny and challenge. The PwC report was used as an aid in formulating ideas and options. Whilst the PwC report suggested that a reduction in the number of funds would optimise the benefits, this project stage required consideration of all possible outcomes including the status quo.

The Project Board at its meeting on 2nd December 2011 also set out additional factors regarding the scope of the project. It was agreed that the project should be contained within a Wales public sector model only (no outsourcing and third party options) and that the potential for collaboration with English Pensions Funds should be noted but is not considered part of this particular "Welsh" project.

## Anticipated Benefits

A key deliverable for the project was the development of a clear vision for the future. Although the underlying requirement to consider service standards, efficiency and improvement, together with cost reduction was already clear, it was important to consider whether any new approach was required and if so, the key outcomes that would be delivered by any new approach. The establishment of a clear set of design principles was therefore seen as important in ensuring a focus on an optimum service solution.

It is accepted that the design principles adopted below are generic rather than specific to Pensions but the principles remain sound and formed an important backcloth to the work undertaken. These principles also helped test the appropriateness of the proposals:

- Reducing costs and sustaining service
- Improving front line service delivery
- Delivering a timely and responsive service
- Improving back office administrative consistency and efficiency of process
- Achieving the most by appropriate collaboration
- Improving the employee/pensioner experience
- Complying with sound governance arrangements and stewardship controls.
- Better information for better decisions.

It is important to note that this review is not just about reducing cost, although that is an important component but it is very much about improving value. Pension Scheme member requirements should drive service standards and delivery, and the way Funds collectively and consistently meet those requirements is at the heart of this report. The goal was therefore to optimise the current arrangements blending both cost and service requirements in the best way. There was also recognition at the outset that cost benefits could take the form of either an absolute reduction in cost or a dampening of future cost growth that may prove less easy to quantify.

## Objectives and Methodology

The objective of this report was to set out the findings of the outline business case which has considered the optimal number of LGPS funds in Wales and the most appropriate organisational structure. This should also include proposals for enhanced collaboration, including, joint procurement opportunities and other efficiency measures.

In order to progress the work, three work stream groups with representation from each LGPS Fund in Wales were established to undertake the following areas of work:

- Investments and Funding
- Financial Modelling (to include Governance and Transition)
- Pension Administration

A project team acted as a co-ordination point across the three groups and provided the conduit through to the Project Board. Within this context, it was considered appropriate to provide a non prescriptive outline of what could be included within each work stream's plans. Knowledge of this is helpful in providing readers with appropriate context. The outline included but was not restricted to:

1. Review of the PWC Report and use of that report as a possible starting point, subject to appropriate validation if, and where required.
2. Updating and validation of core data.
3. Consideration of the 4 options, including implications relating to governance and transition, and objective justification for those discarded and those worthy of further consideration.
4. Consideration of the service delivery issues:
  - Service components such as standards of service, people, IT, accommodation etc...
  - Pros and Cons of different options

- Barriers to implementation/change
  - Assessment of options against the design principles
5. Views of wider stakeholders or research undertaken.
  6. Views on timing of any agreed change proposed.
  7. Conclusions and Recommendations.

## Overview of Current Position

The governance and management arrangements for the LGPS in Wales are a legacy of the Local Government Superannuation Regulations 1974 made under the Superannuation Act 1972. This prescribed that there should be separate LGPS funds for each of the 8 newly created County Councils covering all local authority employees and other eligible employees in Wales. The 8 Funds and their administering authorities are as follows:

- Cardiff and Vale of Glamorgan Pension Fund(Cardiff)
- Clwyd Pension Fund (Flintshire)
- Dyfed Pension Fund (Carmarthenshire)
- Greater Gwent Pension Fund (Torfaen)
- Gwynedd Pension Fund
- Powys Pension Fund
- Rhondda Cynon Taff Pension Fund
- Swansea Pension Fund

Following the further re-organisation of local government in Wales in 1996, this situation remained with the designation of administering authorities set out in the Local Government Re-organisation in Wales Regulations 1995.

At the last Valuation in 2010 there were approximately 280 participating employers across the 8 funds with 160 scheduled bodies (councils, police and fire authorities, universities and colleges ) and 120 'other smaller employers' such as Community Admission bodies (local charities, community councils) and Transferee Admission Bodies (typically short term contractors). In addition there are also nominal assets and liabilities from previous employers such as the pre 1996 County Councils and District Councils.

There is no single model of governance in operation across the 8 funds and in some cases delegation has been made to a Pensions Committee, an Investment Panel or directly to the Chief Financial Officer. In addition, representation also varies within each structure. Some funds have other employers and member representation on their main committee/panel. Others have established consultative panels/representative forums comprising elected members from the administering authority, representatives from other unitary authorities and participating employers, fund members and Trade unions. The 8 funds also have different independent advisors, investment consultants and actuaries.

The LGPS in Wales as at 31<sup>st</sup> March 2011 had 288,882 members (**282,615** as at 31<sup>st</sup> March 2012) (source: DCLG SF3<sup>2</sup>) as follows:

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<sup>2</sup> [Department of Communities and Local Government SF3 Pension Fund Returns](#)

**125,596 ( 43.5%)** Active contributors  
**75,758 ( 26.2%)** Pensioners  
**87,528 ( 30.3%)** Deferred members

The Funds have assets of **£9.289 bn** as at 31<sup>st</sup> March 2011 (SF3) with Fund size ranging from £0.348bn to £1.661bn. Asset allocations and funding strategies vary considerably. Investment management costs amounted to £29.158m in 2010/11 with a further £8.880m spent on administration. Total staff numbers amount to over 140 including 131 administration staff. The full time equivalent is 128.

## Investments and Funding

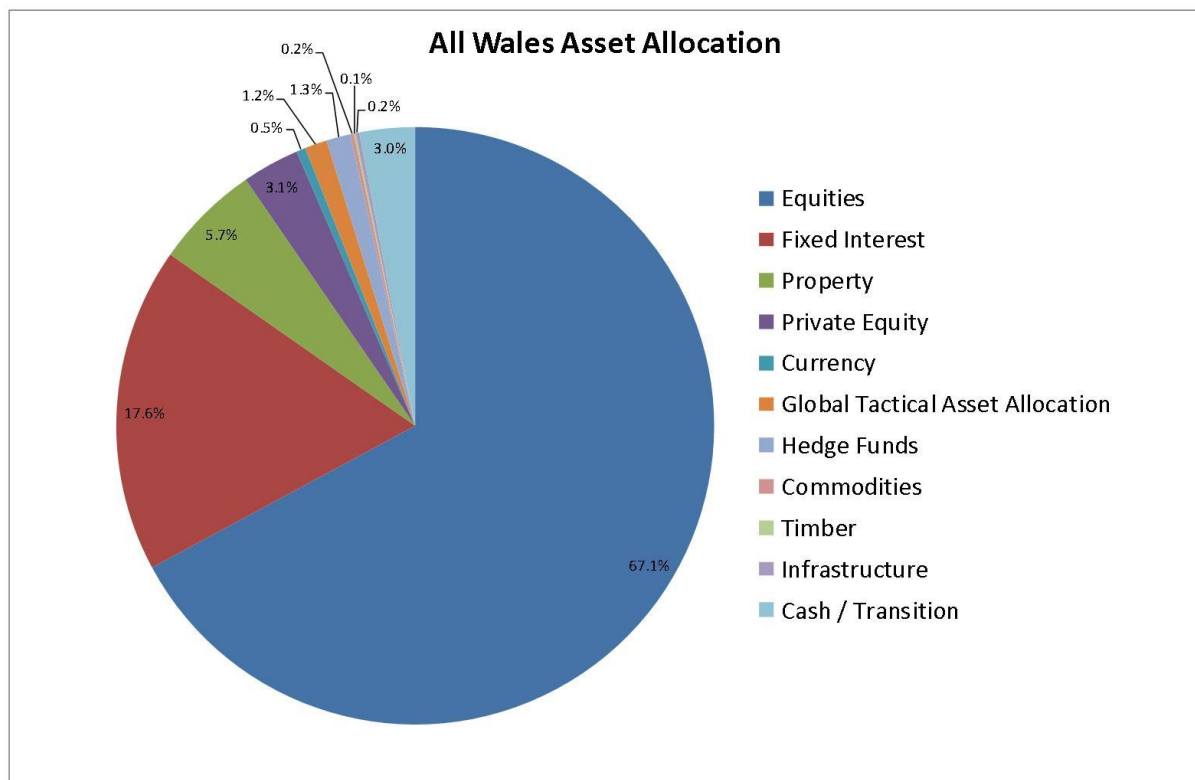
### Background

The current 8 individual funds in Wales have Assets amounting to £9.289bn (value as at 31<sup>st</sup> March 2011), which if combined would place it in the top 5 by market value amongst LGPS funds. The respective total market value by fund and the Investment Valuations (excluding year end adjustments such as creditors/debtors etc...) are shown in the following tables.

| FUND         | Value By Fund |              |
|--------------|---------------|--------------|
|              | £M<br>2011    | £M<br>2012   |
| Cardiff      | 1,111         | 1,166        |
| Clwyd        | 1,052         | 1,061        |
| Dyfed        | 1,348         | 1,401        |
| Gwynedd      | 1,024         | 1,050        |
| Powys        | 348           | 372          |
| RCT          | 1,639         | 1,712        |
| Swansea      | 1,106         | 1,120        |
| Torfaen      | 1,661         | 1,666        |
| <b>Total</b> | <b>9,289</b>  | <b>9,548</b> |

| Investment Valuations<br>(by Asset Class) | 2011<br>£M   | %    |
|---|--------------|------|
| Equities                                  | 6,182        | 67.1 |
| Fixed Interest                            | 1,617        | 17.6 |
| Property                                  | 520          | 5.7  |
| Private Equity                            | 285          | 3.1  |
| Currency                                  | 45           | 0.5  |
| Global Tactical Asset Allocation          | 106          | 1.2  |
| Hedge Funds                               | 116          | 1.3  |
| Commodities                               | 19           | 0.2  |
| Timber                                    | 12           | 0.1  |
| Infrastructure                            | 21           | 0.2  |
| Cash / Transition                         | 277          | 3.0  |
| <b>Total</b>                              | <b>9,199</b> |      |

Investments within each fund include different asset classes. The combined asset class analysis of the 8 Welsh funds is shown in the following table.



Each fund has its own Funding Strategy currently based on the 2010 Actuarial Valuation results as shown in the following table. These funding rates are based on each fund's individual actuarial assumptions agreed by each fund and its actuary but which differ across the 8 Welsh funds.

|                | Funding level<br>% | Employer Rate<br>% | Actuary | Deficit recovery<br>years |
|----------------|--------------------|--------------------|---------|---------------------------|
| <b>Cardiff</b> | 71                 | 23.2               | Aon     | 25                        |
| <b>Clwyd</b>   | 72                 | 20.7               | Mercer  | 20                        |
| <b>Dyfed</b>   | 91                 | 15.2               | Mercer  | 17                        |
| <b>Gwynedd</b> | 84                 | 22.1               | Hymans  | 20                        |
| <b>Powys</b>   | 71                 | 21.8               | Aon     | 25                        |
| <b>RCT</b>     | 70                 | 20.4               | Aon     | 25                        |
| <b>Swansea</b> | 71                 | 20.5               | Aon     | 25                        |
| <b>Torfaen</b> | 74                 | 19.0               | Mercer  | 20                        |

Practitioner discussion, knowledge sharing and joint research in this area examined the four options and concluded the following:

### 1. “As Is”

- Existing arrangements provide a localised solution, which facilitates effective communication and stakeholder engagement.
- Risk is inherently diversified by the very nature of having 8 separate funds.
- Maintaining the status quo provides consistency and continuity, for example all funds are currently in the process of implementing and seeking to deliver their own investment strategies which have been duly and professionally considered.
- The do nothing option should not be viewed as such insofar as **increasingly greater collaboration is already happening**, albeit mainly in the administration area. **There thus remain further opportunities to expand the existing collaboration** which might for example include fully exploiting procurement opportunities through joint arrangements, particularly through those areas such as fund management arrangements which are less well developed
- There are no change management issues to deal with, such as staffing, relocation, impact upon employment opportunities across Wales.
- Corporate Impact – Pension Funds are already currently benefiting from economies (and efficiencies) of scale, for example from Administering Authority existing / embedded facilities, IT systems and services.

### 2. **Enhanced Collaboration**

- There is a lack of collaborative examples in the Investment and related areas (advisors) and there is thus the opportunity for increased and more specialised procurement and development of Framework Agreements, with
  - Potential savings in staff time
  - Facilitation of change options in aspects such as training, legal support and actuarial advice

- The potential to consider beyond Wales
  - More suitable for legal, custodial, actuarial services
  - Enhanced Fund Management arrangements
  - Longer term partnership working with third party service providers
- An oversight model where the 8 funds were retained but managed centrally appears to have the disadvantages of one fund without any of the potential advantages from mandate consolidation etc.
- There is undoubtedly an opportunity to enhance (more formally) the sharing of existing expertise and resources across the 8 Funds. This could be developed specifically around systems, procurement and an expansion of the communications work already undertaken
- **A Common Investment vehicle or Fund would provide an opportunity to achieve the benefits referred to** above. Such a mechanism could be applied to specific assets types ranging from mainstream equities to alternatives such as infrastructure. A development in this direction might increase the ability of LGPS Funds to consider investments in a range of investments that have wider economic benefits within Wales, or beyond.
- The potential to enable the movement of investments between Funds to maximise the utilisation of existing mandates does provide an opportunity to reduce appointment costs, timescales and maximise existing arrangements.
- All of the advantages of the “do nothing”/“as is” option.
- Greater collaboration could also be viewed as part of a route-map toward more formal merger at a future stage (if it is deemed viable to do so and upon the satisfying of stipulated criteria – aka “state of readiness”). The counterweight to this is that collaboration requires increased co-ordination and administration and hence any gain must be justifiable and worth the additional effort.

### 3. Grouped Funds

- The basis of determining the optimal number of funds needs to be clearly set out, for example, is it based on:
  - Asset Allocation
  - Geographical
  - Funding Strategies (recovery rate)
  - Funding Level
  - Contribution Rates
  - Different employer type
- If Funding Level, Employer Rate and Recovery Period are accepted as key drivers, then there are clearly well correlated Funds where merger could be considered viable. Further work is needed however, to understand whether there are other significant differences in factors such as life expectancy, age profiles, risk profiles etc.
- Many of the issues of merger which need to be considered will apply equally for a regionalised model as for the one fund model. The cost benefit of a number of mergers needs to be carefully examined against the cost benefit of a merger to one fund for Wales.



- **Subject to the extent of change, transition costs (investment related) are most likely to be significant.** The extent to which these would be the same for any merger (be it regionalised or one Wales) would clearly be dependent upon the basis of the “from” and “to”.
- **Existing arrangements have a variety of different risk appetites.**
- The extent to which closure valuations may be triggered needs to be carefully considered.
- Investment expertise is currently attached to each of the 8 Funds, any regionalised merger would need to consider retention / recruitment issues and in particular continuity. Physical location is clearly a factor to consider in this regard.

#### 4. Merger to One Fund

- Notwithstanding the complexity of change – legislative etc., one Fund for Wales would have a “status” which could be helpful in attracting staff (such as “specialists”) and in having a voice at a national level. The Fund size would make it one of the largest LGPS funds in the country.
- There could be a removal of some small scale duplication, and increased conformity and consistency.
- While equities form the majority of assets for 6 out of the 8 Funds, a range of asset allocations and investment strategies has been adopted. Organisational change would mean a reduction of diversification of risk at a manager level which is inherent in the current arrangements.
- Organisational change would also incur some significant transition costs – investment, change management (staff etc.), together with a potential corporate impact upon current administering authorities back office structures. These aspects are dealt with in more detail within the Costs and Transition chapter of this report.
- Perhaps the key questions in order to justify this proposal Is whether there is evidence to support larger mandates having lower level of fees and whether there is evidence to support improved investment performance of bigger funds? These matters are dealt with later in the report.
- From a purely Investment standpoint, issues of localism are not considered to be a barrier and are less of an issue that what the group perceive might be the case for fund administration.

The results of this practitioner discussion, knowledge sharing and joint research identified the importance of a number of key funding and investment questions encapsulated within the requirement to provide a high level estimate of the impact on contribution rates and funding levels of using revised or common assumptions under the various collaboration options. A piece of work was thus commissioned to address via specialist actuarial advice the questions (Appendix 1) which were deemed as critical to the assessment of the optimum way forward. Hymans Robertson produced a report in response to this brief which rebased comparisons

between the 8 Welsh funds using a common set of financial assumptions. In response to the questions raised, they concluded that:

- **A common funding and investment strategy could, but need not be applied across all of the Welsh funds since it is not seen as a necessity to gain financial benefits.** There are other options referred to in this report that achieve the benefits in a less disruptive way without having to reach a common funding or investment strategy. A move to such a strategy would be a long term target and the transition to a common strategy could take place over a period of time with different paces of funding and different levels of risk for any Fund making a change.
- If the number of Funds were to be reduced, then the two most likely criteria for grouping funds to minimise impact on long-term funding arrangements would be grouping to optimise operational capabilities or grouping by funding level.
- **Differences in approach to setting financial assumptions are likely to have the most impact on the funding level but it is understood why there are local differences** (e.g. attitude to risk and historical local differences). Thus standardisation of actuarial assumptions and funding strategies would have an impact on employer's contributions.
- **To reduce employer contributions by 0.1% of pay would require savings of circa £2m per annum.**
- **Ten year historic investment returns for LGPS funds in England and Wales show evidence of some correlation between size of investment funds under management and net of fees performance. Research suggests however that larger funds have better governance and alignment with objectives and it is not merely to do with scale.**

This latter aspect was endorsed via statistical analysis and commentary that was obtained from State Street Investment Analytics (WM Company) which corroborated the trend that larger funds tend to produce higher investment returns (net of fees) over the longer term.

The evidence collected appears to show that from an investment management standpoint; there are no insurmountable barriers to merger, although a collective investment vehicle could provide most of the same benefits over a shorter period with less risk than full merger. Key considerations include:

- impact on contribution rates for employers
- cross subsidy issues arising from pre merger positions

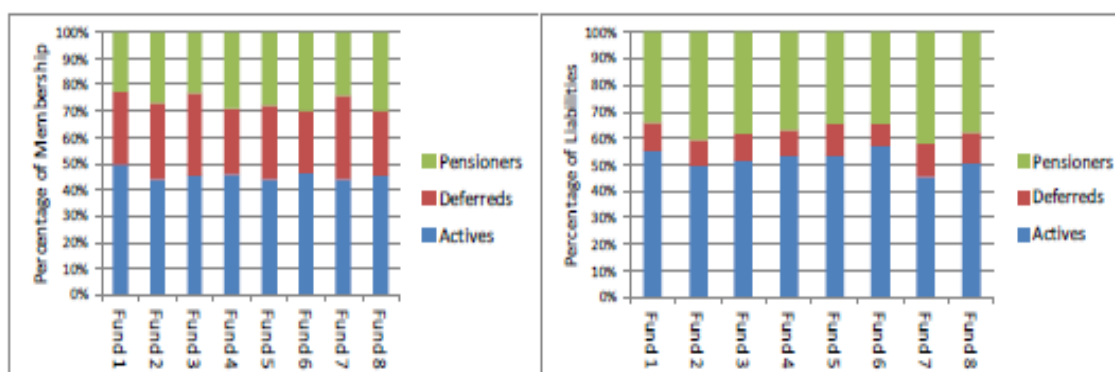
Closer examination of the results, together with the external advice provided, enabled further comment to be made on the funding and investment issues. These are outlined in the following paragraphs grouped around the areas of strategy(S), investment return (IR) and cost(C).

## **Investment Strategy(S)**

In order to undertake the modelling within this report it is necessary to note that an indicative investment strategy was used which seeks to achieve a required level of return at an appropriate level of risk. This is illustrative only but is set out as in the Costs and transition section of the report.

## Standardising Actuarial Assumptions(S)

There are no significant differences in the membership or liability profiles of the individual Welsh Funds.



All eight funds have broadly similar profiles, whether measured by numbers of members in each category, or liabilities. In terms of numbers, around 45% of members are active, with the remaining 55% split broadly equally between deferred and pensioners.

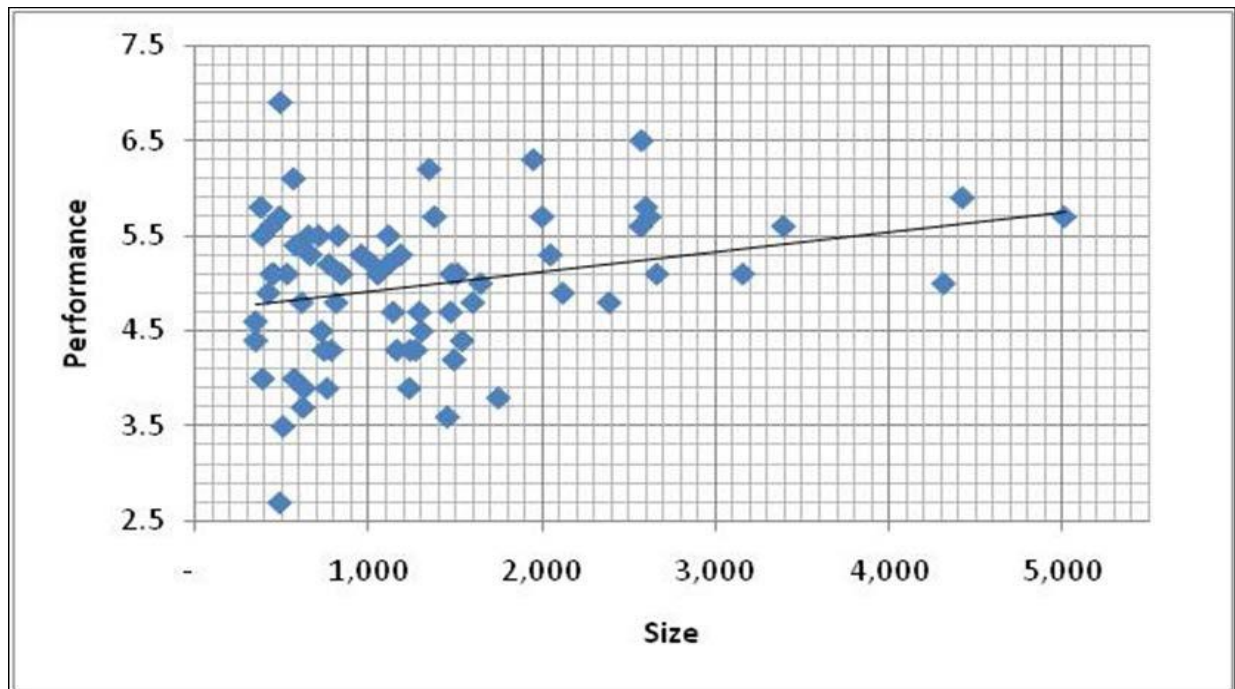
However, there are a range of different sets of actuarial assumptions used which reflect local circumstances such as appetite for risk. Re-basing to a common set of actuarial assumptions shows a greater disparity between funds, in relative terms, albeit this does not mean that merger would prompt an immediate increase in contribution rates.

In practice, a move to a single funding strategy, using a common funding target on the same assumptions, could still permit retention of the current contribution rate strategies in the short term.

Following any merger of funds a common set of actuarial assumptions would be needed for future valuations of the merged fund. This would have an impact on employer contributions.

## Benefits of Size (IR)

From the advice commissioned, it is apparent that there are benefits of size in large funds, although better returns cannot be guaranteed. Hymans' analysis over the 10 years to 31<sup>st</sup> March 2011 suggests that benefits of size accrue incrementally in funds greater than £5 billion in value. These **benefits come from wider characteristics rather than simply the quantum of funds invested.**



The table shown excludes the 3 largest funds, partly because the x-axis scale would be dragged to the right and partly to ensure that the chart was not overly influenced by these three Funds. Including the three funds would not however have changed the picture. There is significant dispersion of returns around the line of best fit. **It is believed that it is the economies of scale that can result, together with size which can lead to improved investment return.** Any improved return is likely to be a function of improved governance, as larger Funds are likely to have greater resource applied to aligning the interest of managers with the Fund objectives.

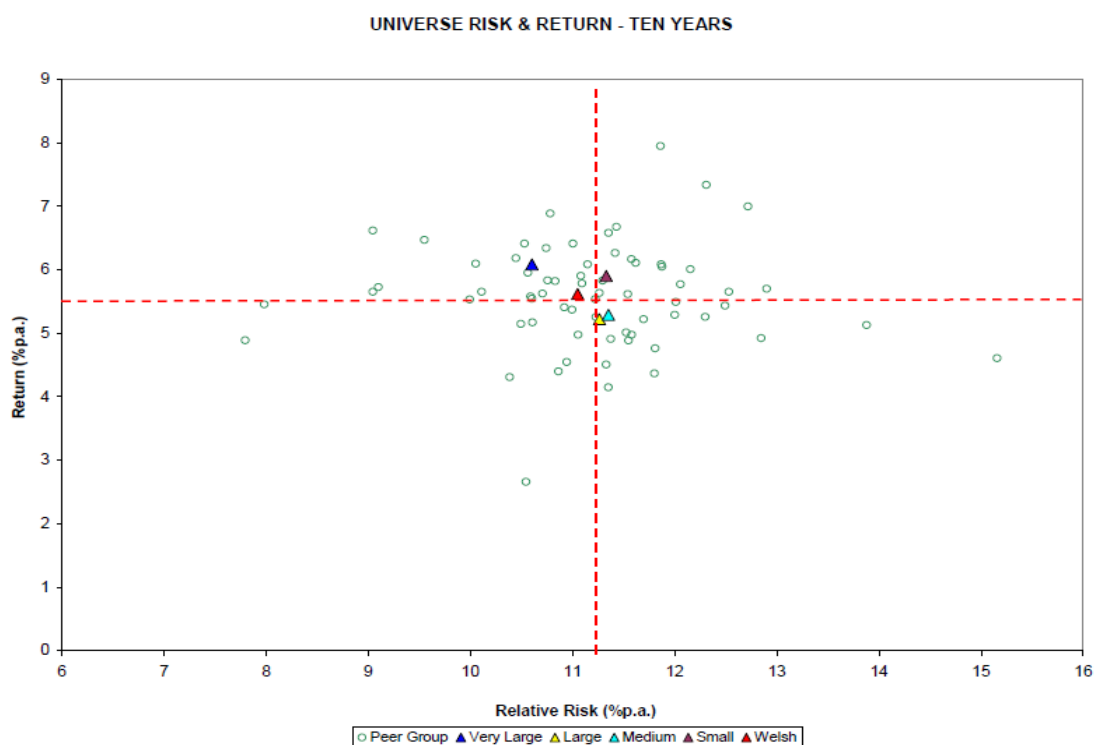
The wider characteristics include governance structures which enable more timely decision making, more internal specialist resources, hands-on management and in-house management of investments.

It is also important however to understand the extent to which benefits of size and scale can be achieved through greater collaboration more quickly than might be the case through a full merger. It is possible to achieve some of these benefits through pooling investment resources and managing investment funds collectively across Wales as an alternative to a full merger into one fund.

### Maximising Investment Returns at Lower Risk (IR)

There are clearly significant risks associated with forecasting future Investment return. However there is a statistical correlation between size of fund and investment return, whereby larger funds appear to be able to achieve higher returns at lower risk. This has been analysed over a 10 year period (see above) and appears likely to be the result of economies of scale that together with size allow improved governance and the potential for increased return.

Further analysis and comparison of the average of a group of “very large” funds against the “all Wales” average undertaken by State Street (WM) (see chart below) showed outperformance in the region of 0.6% with lower levels of relative risk for very large funds as illustrated in the chart below. If simply replicated in practice, a theoretical outperformance of 0.6% on £9 billion would amount to an additional £54 million of investment assets being generated.



*This chart shows the ten year risk and return for the peer group this time overlaying the median outcomes by size band. What this shows is that the very largest funds have delivered the best return at considerably lower risk. (Source WM Company)*

Hymans also analysed all fund performance and size and plotted the linear, again demonstrating a general statistical trend of higher investment returns when a larger amount of investment assets is grouped together and invested.

**Whilst additional investment return cannot be guaranteed, any improved performance, however marginal, is likely to result in significant benefits in monetary terms given the aggregate value of Welsh Funds.** For example, improved investment performance of around 0.22% - about one third of the outperformance observed above equates to 1% of employer contribution rates across Wales and given the uncertainty of investment returns and organisational change requirements, it is not unreasonable to moderate expectation. This is particularly true given the lead in time to progress any changes, the wider changes in the pensions industry and the fact that some of the benefits of size might not be realised in the short term if there is a need to create a new investment organisation. The result via enhanced collaboration or a merger could be gradual improvement over a number of years but this would only be reflected from perhaps 2017 (after the next Actuarial valuation). It is also important to emphasise that the **evidence supports higher investment returns when a larger amount of investment assets is grouped together and invested. This does not require organisational change and can be achieved with existing organisational structures through enhanced collaboration.** This is an important area that requires a more in depth examination in order to produce a detailed business case.

## **Transition (C)**

Transition costs will be incurred when funds move from one investments allocation to another. These costs should not be underestimated and can form a significant cost component affecting any change proposals. The illustrative costs of moving from different types of current investment structures to the above model are shown in the Financial (Costs and Transition) section of this report. This illustrates the short term impact of merging current investments into one investment strategy.

In practice the transition could be undertaken over a short period or extended over a longer period to spread the impact of these costs. Details of potential transition costs are included in the Costs and Transitions section of this report.

## **Fund Management Cost (C)**

Fund manager fees are inherently complex with some performance related drag and some elements of fees not being transparent (e.g. pooled funds). They are also not the key determinant in fund manager and asset allocation decisions, typically attracting a small weighting (20-30%) in manager appointment processes.

Details of the potential savings on Fund Management Costs are included in the Costs and Transitions section of this report.

## **In House Investment Management Costs (C)**

These are currently minimal at around £0.6 million.

One of the characteristics of larger funds appears to be the extent to which investments are managed in-house. Larger fund size appears to attract increased levels of in-house management, with appropriately skilled and experienced in house staff. Welsh funds do not generally invest in this way and do not have the necessary skills currently in place to do so.

## **Realising Cost Savings at an Employer Level (C)**

The prospect of employers being able to realise the impact of any "savings" (from say increased investment return or from cost savings) is one step removed due to the funded nature of the LGPS which involves the triennial valuation process and the associated setting of contribution rates. The issue of materiality of savings relative to £9 billion of investments and the many other continuously moving assumptions and asset valuations is also of relevance.

In order to be able to get a measure of impact, the question was addressed with Hymans that assuming everything else stayed the same what level of savings within funds would be required to achieve a 0.1% reduction in employer contribution rates. It is recognised that this is wholly hypothetical in terms of many things having changed significantly since the 2010 valuation and indeed any savings within pension funds might actually be more about cost avoidance than cost savings – but for the purpose of the report it is helpful in terms of any positive impact upon employers, and their pension contributions.

The pensionable pay bill for those in the LGPS across Wales amounts to circa £2 billion, and to achieve a 0.1% saving on contribution rates (which would save employers £2 million) would require a corresponding saving in pension funds, either

through reduced cost or increased income. Thus, for every £1 improvement in the finances of pension funds, this can be seen to pass through into contribution rates, so employers will see the benefit of reductions in pension fund costs / improved investment returns.

It needs to be stressed that the current outlook and reality is a potential worsening funding position across all funds (not just Welsh funds) and that any cost benefit which might be achieved is likely to be more about future cost avoidance or dampening future cost increases

At this juncture it is important to recognise that for any merger proposition, the lead time to benefit realisation is protracted and a number of steps removed. The legislative framework would require changes to legislation which are within Central Government control (not Welsh Government) and may well be complex and involve lobbying of central government. This aspect is covered in more detail in the Governance section of the report.

## Conclusion

Each pension fund is seeking to achieve a return on its investments in line with its own investment strategy (funding strategy statement). It does not necessarily follow that each fund is attempting to solely maximise return, since any investment return achieved must be within appropriate levels of risk.

At its basic level however, if large funds are able to deliver increased returns at the same or lower levels of risk than the existing 8 Welsh Funds then this is something which needs further consideration.

Fund manager fees, whilst relatively minor in comparison with assets under management (£22.3 million fees on AUM of £9.2 billion), are nonetheless a significant monetary value. The results of analysis demonstrate a general statistical trend of higher investment returns when a larger amount of investment assets is grouped together and invested. This is in part due to the potential for larger funds to be able to access lower fund manager fees which whilst not material to the value of assets under management are nonetheless significant in monetary terms and the potential cannot be discounted.

Whilst additional investment return cannot be guaranteed from combining funds any improved performance, however marginal, is likely to result in significant benefits in monetary terms given the aggregate value of Welsh Funds. Improved investment performance of only around 0.22% equates to 1% of employer contribution rates across Wales and appears a more realistic target or aspiration. This is because of the uncertainty of investment returns and organisational change requirements, the lead in time to progress any changes, the wider changes in the pensions industry and the fact that some of the benefits of size might not be realised in the short term if there is a need to create a new investment organisation.

The results brought about by any enhanced collaboration or merger would only be reflected from perhaps 2017 (after the next Actuarial valuation). It is also important to emphasise that the evidence supports higher investment returns when a larger amount of investment assets is grouped together and invested. This does not require organisational change and can be achieved within existing organisational structures through enhanced collaboration. This is an important area that requires a more in depth examination in order to produce a detailed business case.

It does not necessarily follow that full merger is the way forward. Enhanced collaboration is a vehicle through which many of the benefits of scale might be achieved, whilst retaining an element of local control within existing governance structures, and with realisation of benefit being possible over a shorter timeframe. This would also allow individual funds to continue with their existing actuarial assumptions based on local decision making removing the risk of adverse impact on employers' contributions following change of assumptions on a merger.

On the basis of the evidence we have seen however, there is, from an investment standpoint, a prima facie case for change and an appropriate programme of works should be put in place to maximise the benefit which can be realised through greater collaboration, including specifically managing Pension Fund Investment assets on a collective basis.



# Governance

## Background to LGPS Governance

The LGPS is a common scheme throughout England and Wales. As a statutory public service scheme, the LGPS has a different legal status compared with trust based schemes in the private sector. Matters of governance in the LGPS therefore need to be considered with proper regard to the legal status of the scheme. This includes how and where it fits in the local democratic process through local government law and locally elected councillors who have final responsibility for its stewardship and management and have a clear fiduciary duty in the performance of their functions.

Eighty nine local authorities have been given statutory powers by UK Government to administer the scheme. Under legislation a local authority can delegate their functions through their own constitution to the council, committees, sub-committees or officers. However, the statutory decisions are not the responsibility of the Executive arrangements of the council.

The appointing council decides upon the number of members of a committee and their terms of office. They may include committee members who are not members of the appointing council. The formal committee structures operated by individual pension fund authorities reflect local circumstances and priorities and it has not been the aim of Government to prescribe a 'one size fits all' approach. The evidence collected by the CLG in 2006, and included as part of CLG's Statutory Guidance on Governance Compliance Statements issued on 3rd December 2008 indicated that the overwhelming majority of these committees operate efficiently and effectively despite their variations in constitution, composition and working practices.

Over recent years, CLG, Lord Hutton and CIPFA have published guidance on governance; CLG's being statutory guidance on Governance, where each authority is required to publish a Governance Compliance Statement on a 'comply or explain' basis. The intention as explained by the CLG was not to 'level out these differences' but instead to ensure that different structures reflect best practice principles. More detail on these publications is set out in Appendix 1.

The Public Service Pension Bill will also include consideration of LGPS Governance and overall scheme cost management, which is known as work stream 2 of LGPS 2014. The LGA and trade unions alongside Government have released a joint statement with 12 proposals and those relevant to governance are set out in Appendix 2a.

It appears that changes to Regulation will be forthcoming which will reduce the level of discretion in local governance structures, retaining local democracy but with greater scrutiny. This will question different approaches, working practices and the knowledge and skills of those making and advising on the decisions. These proposals on the whole simply underline and possibly impose earlier best practice from the CLG.

There are specific governance issues to consider within the Local Government Pension Scheme (Management and Investment of Funds) Regulations 2009. Throughout these Regulations reference is made to the requirement for an administering authority to take 'proper advice' when considering investment policy, investment manager appointments and monitoring. It is usual practice for an administering authority to appoint an investment consultant to provide this 'proper advice' and an independent advisor to consider the quality of this advice.

Officers of the administering authority should as a minimum have sufficient knowledge to advise on any conflict of interests with advice received. Some larger LGPS funds employ investment specialists who manage some of the fund internally (instead of through external fund managers) and hence they should have the knowledge and skills to provide 'proper advice', but these funds are in the minority.

As required by the above Regulation an administering authority must publish a Statement of Investment Principles (SIP) which must include the extent to which it complies with guidance given by the Government. This guidance includes CIPFAs Investment Decision Making and Disclosure, which is a guide on the application of the six Myner's Principles (Appendix 2b).

To complete the governance picture as well as the Governance Compliance Statement and SIP discussed above, LGPS Regulations require an administering authority to publish a funding strategy (after taking advice from an Actuary) and a Communication Policy. In addition Regulations allow administering authorities to establish a Pensions Administration Strategy which includes the power to introduce local performance targets and to measure performance against them. All these measures are designed to make the administration and stewardship of the scheme transparent and accountable to its stakeholders. The best practice guidance assists administering authorities with managing LGPS risk areas (Appendix 2c)

## LGPS Governance in Wales

In Wales, as with England, **there is no single model in operation across the 8 funds** and in some cases delegation has been made to a Pensions Committee, an Investment Panel or directly to the Chief Financial Officer. In addition, representation also varies within each structure. Some funds have other employers and member representation on their main committee/panel. Others have established consultative panels/representative forums comprising elected members from the administering authority, representatives from other unitary authorities and participating employers, fund members and Trade unions.

The 8 funds have different independent advisors, investment consultants and actuaries. In addition the roles and responsibilities of the officer support for pension fund finance varies across the funds and most officers also have none pension fund duties and responsibilities. Working practices vary but none of the funds employ investment specialists to manage investments in house. The funds have a range of 3 to 5 individuals involved with accounting, investment and governance but this equates to only 1 to 3 FTE's (about 18 FTE across Wales) which reflects the differing working practices and fund size.

Each Administering Authority has a section which administers LGPS benefits. These vary in size from 8 to 26 individuals dependent in the main on fund size. However, organisation structures, operational models and working practices vary across these sections.

Hence in Wales, as across the whole LGPS, local decision making, based on advice from different advisors, has lead to different outcomes especially in terms of investment structures, funding positions, employer contributions and consistency of the administration (benefit) service provided to members. This should not alarm or surprise stakeholders as the governance structure explained above is designed to provide for local decision making and accountability and differences are an inevitable and acceptable consequence. As noted earlier it appears that the LGPS will still be managed locally in England but with more collaboration between Funds and greater scrutiny on the need for differing approaches to the risks outlined above.

The various governance options for the management of the Scheme in Wales are now considered.

## As Is

The current governance arrangements in Wales have been in place since 1996 and there are differences in strategy, organisation, working practices and outcomes across the funds. If there is a desire to have a more consistent approach, as the benefit of these local differences comes under closer scrutiny, those charged with current governance must be satisfied that the benefits from collaboration can be implemented on a piecemeal basis without a change in the governance structure.

CIPFA has led on initiatives and advice for practitioners through the CIPFA Pensions Panel and CIPFA Pensions Network and there are many opportunities available for elected members and officers to network and share ideas. The CIPFA Knowledge and Skills Framework and Code of Practice should also improve governance. A number of framework agreements for efficient procurement of third party services are also now available.

There are already good examples of collaboration within the current structures especially joint initiatives in pension administration and on responsible investing through the Local Authority Pension Fund Forum. These tend to come about as a result of external drivers providing opportunities for change and collaboration rather than through a programme of collectively planned collaboration.

It should be noted that in terms of governance it is unlikely that 'as is' will be an option because of changes driven from LGPS 2014 as detailed in the Background section. It could be argued that this change alone will be a driver for improvement in the governance of the Scheme.

## Enhanced Collaboration

In this scenario each of the 8 Council's would maintain their administering authority status and each would have a Committee (or Board) which satisfies the requirements of LGPS 2014 in terms of structure and representation. These 'Boards' would continue to determine and implement strategy locally.

The key question is **what sort of governance mechanism would drive such collaboration**, especially if it were for example focussed on investment related matters. One approach is a Joint Sub Committee (JSC) that could be formed with the principle aim of driving and implementing collaboration

There is more than one option within this approach that could be considered, together with various issues for discussion and resolution:

- i. A Joint Sub Committee could either be elected members advised by officers or a more autonomous group of elected members who appoint a third party or specific officer(s) who would report and be accountable to them. In effect, it could be a specialist unit advising and delivering investment related procurement solutions on behalf of any of the 8 pension Funds who wished to participate.
- ii. A further option might be create a JSC of the current Chief Finance officers of the 8 administering authorities (with other senior pension officers as substitute members). This JSC and its delegated powers would be recorded in each of the administering authorities' constitutions.

- iii. Another model could simply be that each pensions committee has to agree to a proposed investment and that decision is actioned by the collaborative body.

Whichever option was favoured, much detail would need to be worked through. Regardless of the option, these would include matters such as:

- **The level of delegation from the 8 main committees (it would need to be decided and documented)**
- the level of consistency across the whole of the eight funds.(or is it simply a Fund chooses to be in the collaboration or not)
- Given that Strategic decisions would remain with the main committees, does the JSC only have the power to recommend, depending on how it was set up and constituted.
- Other, operational decisions would need to be determined. Dependent on the structure, this could be perceived as a loss of control by the administering authority and there will be some debate on what is strategic and what is operational but the concept requires more detailed examination through the production of a detailed business case.
- The JSC may also wish to consider the use of a single investment consultant and/or independent adviser. As stated earlier these organisations or individuals are key in the decision making process and if all eight administering authorities (via the JSC) receive consistent advice then over time logic would suggest that strategy should become more consistent, where appropriate. This could be extended with the joint procurement over time of other third parties such as actuaries, fund managers, custodians, legal advisors, tax advisors etc. As well as the advantages of consistency, joint procurement may result in lower overall cost and a reduction of the operational burden on finance sections.
- In addition there could be two pension practitioner groups' who would research and recommend collaborative opportunities to the JSC, overcome barriers and implement. Groups might include an Administration Group (current Pension Officer Group) and a Finance Group (covering governance, investments, funding and accounting), both with practitioners from the eight administering authorities.

For this governance structure to work the principle of collaboration must be agreed across the 8 funds. Those Funds which choose not to participate in certain collaborative projects will be accountable locally to their stakeholders for this. In simple terms the starting point when considering a collaborative project would be 'why are we not collaborating' rather than 'why should we change current practices'.

The legal advice received considered collaboration and concluded that **'existing legislation provides the Authorities with broad powers to discharge their functions through joint committees for procurement, administration and investment'**. This provides some flexibility in terms of how these governance arrangements could be structured.

The legal advice received did however express **a note of caution in any merging of investments**. Under the Local Government Pension Scheme (Administration) Regulations 2008 there is a requirement to 'maintain' the fund and it must be possible to identify the individual funds investment assets. This can be achieved by creating a separate section for each Authority within a 'common investment fund' or by unitising the assets. However due to the perceived "vagueness" of the wording, there is a concern that such an approach could be interpreted as an over-allocation to a

particular asset class within the Investment Regulations. Consultation with CLG would be recommended here to clarify the intent and interpretation within the existing Investment Regulations. For the implementation of a common investment fund there may be a need to amend secondary legislation. In the current spirit of collaboration across the LGPS it appears unlikely that barriers would be put in place by the CLG, but if change is required, it may not be a quick change due to the existing LGPS legislative workload.

For completeness, although the scope of the above was to consider governance as a whole a JSC could be set up just for specific areas of work such a JSC for passive equity investment or JSC for administration. The options are wide ranging and require further investigation.

### **Merger – (2 - 7 Funds)**

Independent, external legal<sup>3</sup> advice was received on the merger of the 8 pension funds. This concluded that only the UK Government (Secretary of State) has the power to amalgamate funds as a change to secondary legislation is required. The Secretary of State would consider whether it is in the interests of members' and ratepayers'. The legal advice suggests that the Secretary of State may consider a full merger may not be in members' and ratepayers' best interest if the eight Funds funding levels are different. The logic used to support this contention is that such a move may not be seen as being in the interests of the better funded schemes to merge with a less well funded scheme, which could effectively dilute their fund.

Separately, actuarial advice considered the funding levels of the eight Funds using common assumptions identified that there are differences; hence, there is a risk that the Secretary of State could reject a full merger on these grounds.

The legal advice recommended that if the merger option was to be pursued the 8 Councils with responsibility for administering the Pension Funds would need to lobby the Secretary of State. Although they do not have a direct responsibility for the administration of the Scheme, it would be sensible to approach DCLG with the support of Welsh Government but given the heavy legislative workload of the DCLG at present, it may add considerably to the timing of any proposed change in order to implement the required changes in secondary legislation.

Although legal and actuarial advice from one source can always be challenged this approach to change does seem consistent with the democratic governance arrangements for the LGPS explained earlier in the Background section.

The legal advice above applies equally to a merger involving two Pensions Funds as all eight. In essence however, the message here in a legal sense is clear. Collaboration is achievable in a timely manner within the existing legislative framework whereas any proposal for merger will take considerably more time to achieve due to the secondary legislative requirements.

There would be a number of options for structuring the governance arrangements for merged funds including:

- A new corporate body (The Northern Ireland Model)
- One Lead Authority (a current Council would take responsibility for the LGPS for the whole of Wales)

- A Mutual Model (The civil service pension scheme model)

These are equally applicable to a single merged fund, but logic suggests that in the interests of time and cost the larger the number of remaining funds the more likely the lead authority option would be the most appropriate.

In terms of governance specific issues of compliance with statutory guidance etc. logic also suggests that complexity and size will be more easily managed and the risks and costs of change lower than with a full merger to a single fund.

This option does raise a new dynamic in terms of how these funds could be grouped, other than the obvious various geographical splits. Hymans Robertson considered two options 'worthy of further consideration':

- Grouping funds with similar funding levels
- Operational capabilities (identify strengths of individual authorities)

However, they do then comment that whichever option is chosen the governance challenges of retaining local accountability and input into decision making should not be under-estimated. Another consideration of non-geographical options is that this may result in an anomaly in the future if there was another re-organisation of local government in Wales. The other dynamic to consider within this aspect is the perceived or real loss of local accountability from any reduction of Funds and how this could be managed across the 280 or so employers if any change process was initiated.

## **Full Merger – One Local Government Pension Fund in Wales**

As stated above, the legal advice received applies equally to a merger of two funds as to all eight

Similarly, the options for structuring the governance arrangements remain the same as with any merged funds.

The Administration and Investment sections of this report consider to what extent the advantages of merging organisations applies to LGPS funds but there are some specific governance issues to be considered.

However any new structure would need to satisfy the principles of good governance, the current statutory guidance and/or the changes under consideration through LGPS 2014. There is a clear challenge here to develop a governance structure that allows for the representation of stakeholders across the whole of Wales (with the potential to be a structure of great complexity and size) which still allows for effective and timely decision making.

In addition, there will be a period of transition which will incur costs (especially asset transfer costs) and risks. A full assessment would be required on the impact on all the risks which were listed earlier from the lead in period post the formal decision of merger, the transitional period and post the merger.

The whole process from gaining agreement of the 8 Councils, Secretary of State approval and the setting up of the new governance arrangements will take time and cost which are both difficult to estimate. The timing of such a major change, given the implementation of a new scheme from April 2014, the 2013 Actuarial Valuation and current financial market risks needs due care and attention by those currently charged with governance.

## Governance Conclusion

Although any changed governance arrangements in Wales will be largely dictated by the results of detailed consideration of change across administration, investments and broader financial considerations, there remain some specific governance considerations which should not be underestimated.

**In terms of merger, following legal advice this can only be achieved with the agreement of the Secretary of State and a change in secondary legislation.** There are also other risks and costs to consider. Specifically, determining a governance structure to satisfy statutory guidance or the future LGPS 2014 principles (or regulation) would be challenging, but not impossible. The timing of any change given LGPS 2014 and the impact on other risks must not be overlooked by those currently charged with governance.

Due to both the development of LGPS 2014 and the current focus on collaboration it seems unlikely that the 'as is' will be a viable option. However setting this aside, those currently charged with governance, would need to be satisfied that, if there are benefits from collaboration, then this could be managed in a transparent way, and indeed that the end results will justify the change process.

A governance structure to develop and enable enhanced collaboration was considered which included a joint sub committee. There are few legal barriers with this option and there are advantages of relative speed of implementation, simplicity and low cost. This governance structure would drive collaborative projects in a collectively strategic and planned manner over time. In the short to medium term this could enable a more consistent and cost effective approach to managing the scheme across Wales, without losing the local accountability which underpins the statutory governance guidance. In the longer term the increased consistency may allow for more logical mergers, either from choice or driven by any future re-organisation of the 22 unitary authorities in Wales.

# Administration

## Background to LGPS Administration

With 4.6 million members, the Local Government Pension Scheme is one of the largest public sector pension schemes in the UK. The LGPS is a nationwide scheme and is a valuable part of the pay and reward package for employees working in local government or working for other employers participating in the Scheme and for councillors. The scheme regulations are made under the Superannuation Act 1972. Changes to the Scheme are discussed at national level by employee (trade union) and employer (LGA) representatives but can only be amended with the approval of Parliament.

The LGPS has a diverse workforce contributing to the scheme, which requires varying degrees of support and communication.

Benefits Administration teams provide a range of services for current and former employees of local government and other employers participating in the scheme. Their core activities are calculating and paying pension benefits to scheme members but their role extends far beyond this, providing support and guidance to scheme members, often at times of personal change or upset for the member, keeping them informed of the latest developments in the scheme and also ensuring that payments are correct, which means working closely with scheme employers to ensure that information is accurate.

In order to ensure that the scheme is reactive to the extending longevity trends and the subsequent cost implications, the LGPS was subject to regulatory change in April 2008. These changes afforded members specific protections, the result of which increased scheme complexity. Future challenges for the Funds in Wales will, in conjunction with Employers, ensure the implementation of auto enrolment and following consultation and regulation being laid before Parliament (intended to be by 31st March 2013) the 'New LGPS 2014'. The 2014 New Scheme is designed to help address the immediate affordability concerns; however, it will introduce yet another layer of complexity to the existing LGPS administration and as a direct consequence increased membership contact.

## LGPS Administration in Wales

The 8 regional Welsh pension funds are responsible for administering the Pensions for the 22 local authorities in addition to the town, community and other bodies admitted under separate admission agreements. 131 staff are employed across 8 local authority areas providing services for a total of 296 Employers and some 289,000 scheme members. All funds hold local surgeries with their Employers and the availability of face to face support for scheme members.

In terms of the financial context, the existing Funds' Administration charges within Wales compares favourably with Private Sector Administration charges i.e. less than 0.12% of total Funds' assets (Source: Mercer HR).

As part of this review, an Administration Workstream, represented by each of the 8 Funds was identified, with the objective of establishing the current baseline data and level of service delivery at each Fund. The Administration Workstream would use this information to objectively challenge the 'status quo', and identify opportunities to improve efficiency and service to the Welsh LGPS membership, in context of the four service models defined by the Project Board.



All options were tested as part of the work stream's analysis and **the Administration work stream concluded the most beneficial option to the delivery of the LGPS Pensions Administration throughout Wales would be through expansion and development of collaborative work.** In this context it was felt that the alignment of Pensions Administration and Pension Funds should continue; as a single or grouped Administration Service operating a multiple number of Funds would present significant inherent risks. The work of the team is presented in tabular format at Appendix 4 but in essence the conclusion drawn was due to the following key points:

- Whilst the Collaborative model is unlikely to generate significant financial savings, there are tangible improvements to service delivery that can be achieved with minimal risk and disruption to stakeholders, within existing organisational structures.
- The Welsh Pensions Officer Group has been in place for several years, and has proactively sought to collaborate on a number of initiatives. This has successfully delivered and ensured a consistent interpretation and application of Regulations across Wales, whilst also enabling all participants to benefit from cost efficiencies.
- The Pensions Officer Group has already identified that the development of a set of All Wales Service Standards along with the implementation of the 2014 LGPS Scheme is a key juncture for future collaboration and anticipates joint communication, presentations and training for the latter.
- This option would ensure that risks such as provision of varying support and 'face to face' communication needs to the diverse membership is maintained and also continues to address the necessity to provide the service in the medium of Welsh locally.
- There is no real evidence to support groupings or a single entity to be more cost effective or efficient than the current operational arrangements

Comparison with other LGPS Funds was possible utilising data from the DCLG's "SF3" return (below) although there was no data that allowed the workstream to identify in a justifiable way an optimum size of fund.

**Table: Fund Membership Size 2010/11<sup>4</sup>**

| Bandings of Member numbers | Less than 12.5k | 12.5k - 16k | 16k - 18k | 18k - 20k | 20k - 40k | 40k - 50k | 50k - 65k | 65k - 90k | More than 90k |
|----------------------------|-----------------|-------------|-----------|-----------|-----------|-----------|-----------|-----------|---------------|
| Total Funds in Banding     | 10              | 9           | 9         | 9         | 9         | 11        | 9         | 11        | 12            |
| Wales Fund Banding Profile |                 | 1           |           |           | 5         | 1         | 1         |           |               |

<sup>4</sup> Source: SF3 return data for 2010-11

## As Is

While there are some broad similarities between the funds, the current administration arrangements have developed since local government reorganisation in 1996. For a number of years, the implementation of significant changes to scheme administration have been discussed and developed collaboratively through the Pension Officers Group enabling the sharing of experience and skills.

The current arrangements allow service delivery to be alert to scheme member and employer requirements based on agreed local measures; however number, variation in, and consistency of local measures hinder wider benchmarking and setting of service standards. This appears a current weakness that could be addressed via merger or more efficiently and quicker via enhanced collaboration

Comparison with CIPFA benchmarking data for ratios of administration staff to scheme members showed that there were only marginal opportunities to reduce the number of staff currently employed in administration (maximum of 6.82 FTEs). In total, this might generate savings of up to £120,000 per year but this may not materialise as Regulatory complexity increases with the introduction of auto enrolment in 2013 and the new LGPS in 2014. The sum is also small in the context of the 8 Funds (£15,000 per Fund) and secondary to anything that could be achieved around investments.

The ability to provide a local face-to-face service appears to be appreciated by scheme members where available. Whilst difficult to quantify, letters of appreciation from scheme members are not uncommon.

Each fund use the same base IT system but there are some significant differences in the versions used and the way in which the system is configured and utilised that have resulted from local system development.

While there is some scope for further collaboration and potentially some cost avoidance, this can be limited by local resource availability and experience.

## Enhanced Collaboration

**The option of Enhanced Collaboration would build on existing collaborative networks but with the addition of greater governance allowing collaboration to be driven in a planned and strategic way.** This would allow greater cost avoidance and improved consistency of service while minimising transition costs and the risk to current service delivery. It would allow local face to face service delivery to continue and maintain the local responsiveness of the existing arrangements.

The implementation of the LGPS 2014 scheme would be delivered collaboratively and greater consistency in the use of IT would be possible. Sharing experiences of system development and implementation would allow for the maximisation of technological advances. Other collaborative changes may be possible during the implementation of LGPS 2014.

One of the greatest limitations found in the undertaking of this project was the inherent difficulties in collating any meaningful comparable Service Standards and subsequently the inability to identify a potential 'Best in Class' Fund for LGPS Administration across the UK. The following observations were drawn from the project review:

- There are no nationally agreed Pension Administration Service Standards that can be used for performance measurement
- Individual funds set a range of locally determined targets and measures

- IT capabilities to record and report on measures are not fully implemented across all funds in Wales
- Calculation of measures varies considerably (for example: some funds publish percentage completed on target, others the actual number completed, or the average number of days taken to complete; different start and end points are used to capture performance measures making comparison meaningless)
- Publication of targets and measures varies considerably (for example: some publish their target standards but no results)
- CIPFA Pensions Benchmarking Club does not compare Service Standards (in order for this to be successful and a meaningful comparison Service Standards need to be set the same. The current omission by CIPFA is a reflection of the existing inconsistency)

This issue would be addressed through enhanced collaboration and the development of common service standards.

### Merger (2-7 funds)

As discussed above, there are marginal opportunities for reducing costs based on staff-member ratios, but there may be the opportunity to develop specialist roles (e.g. systems or communications officers).

**The scope for making savings through merging the use of a single IT system are limited, in part because all the Funds already use the same IT provider and as costs are based on the number of scheme members which would not change on merger.**

There is a risk that the current levels of local access may no longer be possible, with a further risk that the service may become less responsive to local issues and be seen as increasingly remote.

There is also a timing issue since the implementation of LGPS 2014 would through necessity have to take precedence over the implementation of fund merger. The current level of resources would mean that it would not be possible to implement both concurrently.

Greater consistency and some cost avoidance would be possible through the merger of funds, although this would not necessarily be across the whole of Wales and would depend on the groupings to be merged. Savings, if realised would be extremely small in the context of the service and it is questionable whether the costs of change would justify the level of savings potential.

Common service standards would be developed within the newly merged funds and potentially across Wales.

Existing service delivery is considered to be at greatest risk given the degree of complexity involved in merging and local accountability would be diluted.

### Full Merger

Many of the conclusions reached under the consideration of grouped mergers also apply to a full All Wales merger.

Common service standards, procedures and documentation would apply across Wales but local responsiveness and accountability would be severely diluted.

Again, the implementation of LGPS 2014 would need to take precedence over the implementation of fund merger, and it is questionable whether the quantum of any possible saving would be justified through the upheaval of change. The other important facet here is the legislative and governance issues to be addressed which is dealt with elsewhere in this report.

## Administration Conclusions

The following overall conclusion has been drawn together by the Administration Workstream based on the evidence gathered for each of the four options.

Whilst the Collaborative model is unlikely to generate significant financial savings, there are tangible improvements to service delivery that can be achieved with minimal risk and disruption to stakeholders, within existing organisational structures. This is therefore the option that is recommended.

There is **no real and supported evidence that demonstrates that groupings or a single merged fund would be significantly more cost effective or efficient than the current operational arrangements**. The overall quantum of cost in respect of administration also results in this area being less attractive as an area to achieve meaningful financial benefit.

There is a serious risk that **any major relocation or change from the current Fund deployment would result in a loss of key personnel and ensuing recruitment difficulties, due to the geographical nature and infrastructure within Wales**.

All eight Funds use the same software supplier (who is the market leader in LGPS Pension Software). Evaluation of the systems costs identified that reduction in the number of Funds would not generate material savings. Whilst it is conceivable that some non-direct central recharges may be reduced through economies of scale, any such contrast between the support service requirements of a much larger entity would need to be determined.

Furthermore, the review identified that whilst all Funds use the same administration software, utilisation of the system and processes are configured differently to meet funds individual service requirements. This has created difficulties, particularly in respect of data records in the past where organisations previously regionalised in Wales have been merged into a single body.

## Recommendations

Having given due consideration to the four options and associated risks, the Administration Workstream concluded that the most beneficial option to the delivery of the LGPS Pensions Administration throughout Wales would be through expansion and development of collaborative work, as further identified during this project.

This option would ensure that risks such as provision of varying support and 'face to face' communication needs to the diverse membership is maintained and also continues to address the necessity to provide the service in the medium of Welsh locally.

The Pensions Officer Group has already identified that the development of a set of All Wales Service Standards along with the implementation of the 2014 LGPS Scheme is a key juncture for future collaboration and anticipates joint communication, presentations and training for the latter.

# Costs and Transition

## Background

The costs incurred by pension funds include investment management fees, custodian fees, specialist advisors fees and in-house administration, investment management, accounting and management. The **investment management fees are the single largest regular costs incurred by each fund** and are therefore most relevant for consideration when looking for improvements and efficiencies.

In addition to these annual costs, **any decisions which involve the fund moving from one investment allocation to another, or from one investment manager to another, will result in transition costs. These costs can be significant and therefore need to be considered as part of the assessment of a move to collaboration on investment management.** The potential gain however within this context is a possible improvement in investment returns.

## Investment Strategy

In order to undertake the modelling within this report, an indicative investment strategy was used which sought to achieve a required level of return at an appropriate level of risk. This is purely illustrative only but is set out as follows:

| Asset Category     | Weight | Approach to Management   |
|--------------------|--------|--|
| UK Equities        | 18     | Largely Passive  |
| Regional Equities  | 20     | Largely Passive  |
| Global Equities    | 25     | Themed active (e.g. income or value)                                   |
| Private Equity     | 5      | Existing fund of funds for now   |
| Property           | 7      | Pooled UK Property funds   |
| Credit             | 10     | Emerging market passive and high yield active – no UK investment grade |
| Nominal gilt       | 15     | Short duration (less than 5 years)                                     |
| Index linked gilts |        | Long dated I-L (over 15 years)   |

In practice it would be difficult to agree a common investment strategy due to the diverse investment strategies in the Welsh funds which provide different starting points, and the local circumstances for each fund both currently and brought about over time and the appetite for risk of each Fund which is influenced by these various factors.

## Fund Managers Fees

Each Fund sets its own investment strategy relative to its own liabilities. Fee levels will therefore differ for Fund specific reasons. For example, a more mature fund aiming to minimise volatility will have a different asset allocation to one targeting higher returns; hence each Fund will invest in different asset classes, with different amounts in active versus passive approaches.

Investment strategies consider returns net of fees, and also the additional return which may be possible from performance fees. All large investors pay the same low fee within most tracker funds and then consider the relative value of paying additional fees for some active management with the aim of increasing returns. However, fees are usually of limited importance when deciding whether to adopt active management compared to the excess returns and risk-return characteristics of the active strategy. Many investment manager

contracts have performance related fees which can vary significantly according to the returns achieved against the relevant benchmark.

Thus it is difficult to make comparisons between the fees in different funds when there are many variables affecting their calculation.

At an all Wales level, Fund Manager Costs (excluding custodians, specialist advice etc...) amount to over £22 million. **A study carried out by WM of their LGPS Funds over a 10 year period identified fund manager fee ranges that did appear dependent upon size of fund.** This concluded that funds over £5 billion do have lower levels of fees than funds of between £1 billion and £2 billion. The differential within those funds which are externally managed is circa 0.07%. On assets under management of £9 billion, this statistical trend, if actually realised, amounts to a potential financial differential of £6.3 million.

Many larger funds also undertake more investment activity in-house which further reduces their costs. The differential in fees at an all fund level increased to circa 0.20%. On assets under management of £9 billion, this amounts to a potential financial differential of £18 million.

Hymans have similarly commented on fund manager fees and imply a potential cost saving being achievable from having bigger mandates. Part of these savings could be realised due to the higher bargaining power of larger investors **but larger funds do appear to have certain economies of scale that may influence investment returns in a positive way.**

The extent to which lower fee levels might be associated with older mandates is a key observation here, and one which through greater collaboration might be exploited within existing fund structures. This is due to some mandates being in place over many years and negotiated at times of historically low management fees.

To further explore possible fee savings, the investment strategy provided by Hyman's was used as a base case and independent third party advice was sought on the range of fees currently in the market for these larger mandates. Many assumptions as to the number of fund managers and types of mandates have been made to enable any such comparison to take place so results should be interpreted with care. The market value used for the eight Funds was the mid point of the March 2010 and March 2011 market value to enable some comparison with the £22.3m (total fees for 2010/11). The results are summarised in the table below:

|                     | <b>Assumed Fund Value</b> | <b>Low Fee Range</b> | <b>Mid Fee Range</b> | <b>High Fee Range</b> |
|---------------------|---------------------------|----------------------|----------------------|-----------------------|
| Fund Management Fee | £8.9bn                    | £17.2m               | £19.4m               | £24.8m                |

Therefore, these results broadly further support the hypothesis and some survey findings that larger pension funds can achieve lower fees, of between £3-7m per annum in this example. Albeit should be noted that using all the higher range of assumptions, current fee levels in total are lower. This may reflect current low fees paid for some older mandates or simply the range of assumptions made to enable the comparison.

## **Asset Transition Cost**

Theoretically, if the current assets of the individual eight funds were being employed using the same investment strategy and implemented through the same fund managers then a merger or some kind of pooling or grouping of these assets would result in no change or cost.

However, in practice, for reasons outlined in the Governance section of this report the eight fund have different investment strategies implemented through many different fund managers. Hence, to achieve any potential benefits from merger or collaboration there will inevitably be some transitional cost and risk.

Transition management (i.e. the moving of monies from one asset class to another or from one manager to another) is a specialist area and it is usual for any institutional investor to employ a transition manager to manage costs and risks where a major change in investment strategy is to be implemented. As part of this report, three Transition Managers were approached both to provide some further understanding on the components of the costs and quantify these costs.

The costs are briefly outlined below:

- Commission fee charged by a broker to execute a buy or sell.
- Taxes and fees levies charged by some countries for equity trades e.g. UK stamp duty.
- The 'spread' which is the difference between the purchase and sell price of an investment.
- The market reaction to a buy or sell order and the resulting impact on the price.
- Specific high asset costs in some fixed income securities due to the limited number of counterparties.
- Alternative assets where transactions may be difficult to achieve or at a high cost or discount to market value.

In addition there is also the 'Opportunity Cost or Risk' which is the market movement during the transaction while the investor is 'out of the market'. This can be a positive impact on performance if the market falls during the transaction or negative if the market rises. In times of volatile markets, this can be a significant positive or negative effect.

As referred to earlier in this section, Hymans provided an indicative optimum investment asset allocation structure for a consolidated investment structure at an all Wales level.

Whilst for the reasons provided above, transition costs can vary considerably due to timing decisions, it is nonetheless important to understand the scale of costs which might arise. This is shown in the table below and suggests transition costs of £11m.

| Transition from | Transition to            | Amount to be traded<br>£'000 | Estimated cost<br>£'000 | Estimated cost<br>Basis points |
|-----------------|--------------------------|------------------------------|-------------------------|--------------------------------|
| Existing        | Hymans Report Allocation | 5,815,030                    | 10,979                  | 12                             |

A number of other "transition to" scenarios were also modelled, in order to further understand the range of potential costs. These additional scenarios were identified as representing the two ends of the current spectrum of investment strategies currently used by the Welsh funds. **The transition cost estimates** for these movements were £21M and £46M, as compared to the £11M cost of moving to the Hymans indicative allocation. These costs **are substantial and would have to be factored into any proposals for organisational change.**

The transition managers stress the large number of assumptions made in arriving at the indicative costs and that in reality costs may be significantly different from those above but the important conclusion is that under all scenarios, transition costs are significant monetary sums.

Clearly it is difficult to be precise about the cost of a transition but it is important to recognise there is a 'one off' cost and risk, the quantum of which need to be considered relative to potential cost savings.

## Investment Returns

The Investment and Funding Chapter of this report has already dealt with the issue of size of Fund and the attributes of larger funds that may help improve investment returns. Whilst additional investment return cannot be guaranteed from combining funds through merger or enhanced collaboration, any improved performance, however marginal, is, as previously stated, likely to result in significant benefits in monetary terms given the aggregate value of Welsh Funds. **Improved investment performance of only around 0.22% equates to 1% of employer contribution rates across Wales and this is a goal worth pursuing.**

## Conclusion

Whilst fund management fees and transition costs are significant in terms of value they are not the fundamental drivers of an investment strategy or of changing a strategy.

If the eight Welsh Funds were to merge, the buying power of one new Fund would enable the Fund to purchase mandates at a lower management fee, but the overall reduction in fees (if indeed achieved) as a percentage of market value across Wales will be determined by the new investment strategy and the method of implementation. Equally the evidence would suggest that it is the grouping of assets which is important, not necessarily changing organisational structures. A collective investment approach by Funds would appear to have the same potential to achieve improved investment returns

There would be a significant 'one off cost' of transitioning the assets to these larger mandates under any of the scenarios modelled within the report.

An attempt has been made to quantify the fee reduction and cost of transition but these should be used for illustrative purposes only due to the extent of assumptions made. However, it is not unreasonable to conclude that it could take several years to 'pay back' the cost of transition before any lower fund management fee benefits may accrue.

Whilst additional investment return cannot be guaranteed from combining funds through merger or enhanced collaboration, any improved performance, however marginal, is, as previously stated, likely to result in significant benefits in monetary terms given the aggregate value of Welsh Funds. It is therefore a goal worth pursuing, particularly if it is attainable without significant organisational upheaval.



# Overall Conclusions and Recommendations

## Findings of Investment Work

1. There is evidence that there are potentially significant financial benefits of scale to be found from either merger or working collectively through a common investment approach. The results of analysis demonstrate a general statistical trend of higher investment returns when a larger amount of investment assets is grouped together and invested. There are however no guarantees of improved returns and it does not appear to require organisational change to benefit since enhanced collaboration would achieve the same goal in a quicker and less disruptive way.
2. The potential benefits are not a direct relationship with the size of a fund but **rather the** result of economies of scale that together with size allow improved governance and the potential for increased return **with** a combination of attributes that larger funds tend to have such as
  - More internal / specialist resources;
  - More internal / hands on management;
  - Better diversification – asset classes, managers;
  - More bargaining power on fees;
  - Better, more responsive governance structures and processes in place enabling speedy decision making.
3. Changes introduced as a result of the findings of this paper would not impact on employer contribution rates until the Actuarial Valuation after any changes were implemented (i.e. earliest impact could be 2017/18).
4. It is impossible to predict future investment returns with any degree of certainty.
5. The variety of valid funding assumptions and approaches adopted across Welsh LGPS funds makes comparison difficult and has the potential to significantly cloud the interpretation of a Funds funding position.
6. Given other influencing factors at this time such as changing (increasing) liabilities, changing membership profile, improving longevity and benefit design changes, the impact of any investment benefits are more likely to be a dampening effect on future upward contribution pressures resulting in slower growth in the employer contribution rates rather than a reduction.
7. There are inherent difficulties in adopting a common investment/funding strategy across all Funds whilst they remain independent legal entities. The more appropriate option would be a common approach to the implementation of a Funds strategy rather than the Strategy itself being common.
8. Funding changes are the most complex and lengthy areas for change but also have the greatest potential for cost saving.
9. Investment manager fees amount to some £22.3m per year across LGPS funds in Wales. A common investment approach could provide some modest savings which even if a low level of only 10% saving were achieved would amount to a £2m saving across Wales; equivalent to 0.1% on employer contribution levels. It is important to note however that to deliver such savings would potentially incur significant transition costs at the outset.
10. On the basis of the evidence, there is, from an investment standpoint, a prima facie case for change and an appropriate programme of works should be put in place to

maximise the benefit which can be realised through greater collaboration, including specifically managing Pension Fund Investment assets on a collective basis.

### **Findings of Governance Work**

11. There is much that can be done using a collaborative approach within existing legal, organisational and governance arrangements.
12. Merger cannot be undertaken without a change in secondary legislation at UK level. This would be the most challenging option with the longest lead in time, requiring engagement with both Wales Government and the DCLG.
13. Merger would distance Funds from local accountability and control unless additional layers of governance were introduced.
14. A common investment proposition is feasible within the existing investment regulation framework but clarification on aspects of the Regulations from DCLG would be helpful.
15. A Governance structure to develop and control future collaboration across Wales needs to be established with agreed standards.

### **Findings of Administration Work**

16. Building on existing collaboration and the additional impetus provided by this Collaboration project, can achieve improvements in front line pensions service delivery, consistency and efficiency whilst ensuring compliance with sound governance arrangements and stewardship controls and regulations.
17. A local presence is important for responsive service delivery.
18. The absence of agreed service standards within the LGPS does not help meaningful comparison either within Wales or across UK funds.
19. Administration costs across the LGPS Funds in Wales amount to some £8m per year. Financial benefits identified through the administration work are thus far more modest than those identified elsewhere but should nevertheless be pursued.

### **Findings of Costs and Transition Work**

20. Both fund management fees and transition costs are significant factors but not the fundamental drivers when considering investment strategy.
21. Merger to one Fund or the mechanism of a collective investment vehicle would facilitate potentially lower management fees, but the overall reduction in fees (if indeed achieved) as a percentage of market value across Wales would be dependent on the new investment strategy and the method of implementation.
22. There would be very significant 'one off' costs of transitioning the assets.
23. An attempt has been made to quantify the fee reduction and cost of transition but these should be used for illustrative purposes only as the assumptions are many. In isolation, and prior to factoring in any improved investment return due to size and associated attributes, it is reasonable to conclude that transition costs will be significantly higher than any potential reduction in management fees and thus it could several years to 'pay back'

## Key Recommendations

1. The “as is” or no change option is not supported. The pension’s environment requires a more pro-active approach to managing service standards and costs within the LGPS within Wales.
2. Enhanced collaboration is seen as the area where medium term savings can be optimised. This is the option where the balance of service delivery and efficiency, cost of change, time and resource can be blended in the most effective way and should be pursued further.
3. To create a Full Business Case for a common investment approach to encompass the common attributes that benefit larger funds with the aim of implementation thereafter.
4. To create an appropriate and responsive governance structure to drive and manage future collaboration initiatives within Wales which will:
  - a. explore the potential in the longer term for consistent Valuation and funding assumptions and standards.
  - b. develop minimum administrative service standards for Wales and an agreed measurement framework.
  - c. take advantage of joint procurement initiatives to help consistency and efficiencies
5. The prospect of merger to regional funds or a single Welsh Fund is both complex and the transition would be costly with a long lead- in time and a loss of local autonomy. Changing funding strategies could also have a destabilizing effect with a loss of local accountability. Whilst this may merit additional investigation in the future, it is not recommended for further work at this time, especially where it is believed that the most significant gains can be realised through greater collaboration and, specifically a common investment approach.

## Acknowledgements

This interim report is in itself a true collaborative effort produced by local government officers from all eight Pensions Fund administering authorities in Wales.

The Project Board established a structure of working groups covering administration, investments and funding and financial modelling and governance. Each group had membership from each Welsh Pension Fund and the work produced represented a collective input from many individuals across all Funds with an interest in shaping the future direction of local government pensions in Wales for the benefit of its current and future stakeholders. A project team acted as a co-ordination body to bring the separate work strands together into a single document.

The Project Board wishes to formally place on record its thanks and appreciation to all those officers involved in the project who have spent considerable time and effort, in addition to their existing roles, to produce this report. The work has been considerable and the challenge of achieving sufficient consensus of views and ideas across 8 organisations has been considerable but rewarding. The Board would also like to record its thanks to those third parties who have contributed in a professional manner to the work undertaken.

The Project Board hope that this report stimulates debate about the future direction of the LGPS in Wales and enables an increased confidence that there is a way that the LGPS in Wales can be provided in an increasingly efficient way and operated in both an affordable and sustainable way for all its stakeholders, now and in the future.

## **Appendices**

- 1 Key Funding and Investment Questions**
- 2 Guidance on Governance**
- 3 Extract from Joint Statement relating to Governance**
- 4 Summary of key Points re Administration**

KEY FUNDING AND INVESTMENT QUESTIONS

1. Based on the current funding strategies and membership structures across existing Funds, is it possible to model, in outline terms, a funding strategy to balance existing funding objectives across a single Wales Pension Fund? Following on from that, is it then possible to suggest a basic investment strategy (asset allocation, risk and return targets) to meet that funding scenario? This is for illustrative purposes only (we are not seeking to undertake a wholesale asset / liability study/review) but could be something which might be used for modelling purposes to demonstrate what a potential strategy might look like, and how we can model the transition costs with our transition managers.
  
2. Are there any basic funding rules, or a template or checklist, which might be appropriate to determine any best fit for a regionalised model across Wales? Based on existing funding assumptions, membership structures etc., have you any views upon which, if any, Funds might be more aligned so as to minimise the impact on long-term funding arrangements? Could we then carry out the same analysis as in point 1 above for the suggested regional groupings?
  
3. For enhanced collaboration as well as the status quo option, are there particular actuarial assumptions or aspects of funding strategies which could usefully be standardised? Is it possible to quantify the impact of this on employer contributions?
  
4. Based upon any cost savings being identified as achievable, is there a calculation which could be carried out to demonstrate the absolute or relative level of administrative cost savings would be required to have a positive impact upon employer contribution rates of 0.10% (ie 10bps). That is, if everything else stayed the same, then at the 2010 valuation what level of long-term cost savings would have been required to have reduced employer contribution rates by 10bps?
  
5. The question of Fund size also needs to be explored if possible. Are there any factors from a funding or investment perspective which you feel are generally linked to Fund size? Is it possible to value any such factors, whether positive or negative, and to provide estimates of the potential impact on employer contributions under different scenarios?

## **Guidance on Governance**

There are nine principles to the CLG statutory guidance but underlying these principles is the democratisation of LGPS committees and governance arrangements. The principles are on structure, representation, selection and role of lay members, voting, training/facility time/expenses, meetings (frequency and quorum), access (to reports), scope (to include investment and administration) and publicity (of governance arrangements).

Although compliance with all the above principles is relevant to any changes proposed in this project the first two principles are shown in more detail as they will require particular attention.

### **1. Structure**

- a. The management of the administration of benefits and strategic management of fund assets clearly rests with the main committee established by the appointing council.
- b. That representatives of participating LGPS employers, admitted bodies and scheme members (including pensioner and deferred members) are members of either the main or secondary committee established to underpin the work of the main committee.
- c. That where a secondary committee or panel has been established, the structure ensures effective communication across both levels.

### **2. Representation**

- a. That all key stakeholders are afforded the opportunity to be represented within the main or secondary committee structure. These include:-
  - (i) employing authorities (e.g. admitted bodies)
  - (ii) scheme members (including deferred and pensioner scheme members)
  - (iii) independent professional observers, and
  - (iv) expert advisors (on an ad hoc basis)

More recently **Lord Hutton** considered LGPS governance as part of his report on Public Sector Pensions. His recommendation did not change the local approach to the management of the LGPS when there was an opportunity to do so. However, amongst other recommendations on properly constituted, trained and competent Pension Boards, greater consistency, transparency and scrutiny, there was also mention of central and local government closely monitoring the current co-operative projects within the LGPS, with a view to encouraging the extension of this approach.

In light of this **CIPFA** published a document 'Buying Time' which described a number of co-operative projects which are on-going across the LGPS and published a Code of Practice on Knowledge and Skills in Public Sector Pension Finance for elected members and officers.

### **a. Extract from Joint Statement relating to Governance**

1. Both governance and cost management are equally essential to the future sustainability of the scheme and should not be considered in isolation
2. A national LGPS Board would be set up to include representatives of scheme employers, scheme members, the government and professional bodies. The remit of the board would be to extend best practice, increase transparency, co-ordinate technical and standards issues and provide an effective liaison with the scheme regulator.
3. At a local level we propose that boards provide a greater degree of segregation between funds and administering authorities and that the potential for conflict of interest at both member and officer level is reduced.
4. Membership of local boards is proposed to require a minimum recognised level of skills and knowledge and to include representation for fund employers and trade unions.
5. We also propose that best practice with regard to transparency and accountability is extended across all funds.

### **b. Myner's Principles**

- Effective Decision Making
- Setting Clear Investment Objectives
- Managing liability risks
- Measurement and reporting on investment and governance
- Responsible ownership
- Communication and transparency to stakeholders.

### **c. LGPS Risk Areas**

- Investment risk
- Liability risk
- Employer risk
- Resource and skill risk
- Administrative Risk
- Regulatory and compliance risk
- Reputational risk



## Summary of Key Points re Administration

## APPENDIX 4

|   | <b>Option 1<br/>As is</b>  | <b>Option 2<br/>Greater collaboration</b>  | <b>Option 3<br/>Merger of grouped funds</b>   | <b>Option 4<br/>Single merged all Wales<br/>LGPS Fund</b>   |
|---|--|--|---|---|
| <b>Opportunity for reducing costs</b>                 | None   | Minimal  | Minimal   | Minimal   |
| <b>Risks to sustaining current service</b>            | None   | None / Minimal   | Medium / High   | High  |
| <b>Opportunity to improve front line delivery</b>     | Limited <ul style="list-style-type: none"> <li>– subject to local resource availability</li> </ul>   | Medium / High <ul style="list-style-type: none"> <li>– shared resources</li> <li>– develop minimum standards</li> <li>– some specialisation</li> </ul> | Limited <ul style="list-style-type: none"> <li>– some specialisation</li> <li>– reduced local access</li> <li>– medium risk of loss of experienced staff</li> </ul>       | Low / Medium <ul style="list-style-type: none"> <li>– specialisation</li> <li>– reduced local access</li> <li>– high risk of loss of experienced staff</li> </ul>         |
| <b>Delivering a timely and responsive service</b>     | Medium / High <ul style="list-style-type: none"> <li>– alert to local member and employer needs</li> <li>– based on agreed local measures</li> </ul> | High <ul style="list-style-type: none"> <li>– alert to local member and employer needs</li> <li>– agree consistent service standards</li> </ul>        | Medium <ul style="list-style-type: none"> <li>– less responsive to local member and employer needs</li> <li>– agree consistent service standards within groups</li> </ul> | Medium / High <ul style="list-style-type: none"> <li>– less responsive to local member and employer needs</li> <li>– single set of service standards for Wales</li> </ul> |
| <b>Improve back office administrative consistency</b> | None <ul style="list-style-type: none"> <li>– currently based on local resource</li> </ul>   | Medium / High <ul style="list-style-type: none"> <li>– develop standard processing practices</li> </ul>  | Medium <ul style="list-style-type: none"> <li>– develop standard processing practices</li> </ul>  | Medium <ul style="list-style-type: none"> <li>– standard processing</li> </ul>  |

|  |   |   |  |   |
|--|---|---|--|---|
|  | availability and experience   | <ul style="list-style-type: none"> <li>– develop standard documentation</li> </ul>  | <ul style="list-style-type: none"> <li>– develop standard documentation</li> <li>– risk of difficulties in data collection due to remoteness from employers</li> </ul> | <ul style="list-style-type: none"> <li>practices</li> <li>– standard documentation</li> <li>– risk of difficulties in data collection due to remoteness from employers</li> </ul> |
| <b>Achieving the most by appropriate collaboration</b> | <p>Medium</p> <ul style="list-style-type: none"> <li>– some already achieved through Pensions Officer Group (POG) and Pensions communication forums</li> <li>– collaborative opportunities across UK</li> </ul> | <p>High</p> <ul style="list-style-type: none"> <li>– enhanced governance</li> <li>– LGPS 2014 further opportunity to collaborate</li> <li>– maximise utilisation of specialists eg systems officers</li> <li>– maximise utilisation and development of IT systems</li> <li>– collaborative opportunities across UK</li> </ul> | <p>High</p> <ul style="list-style-type: none"> <li>– further collaboration between merged funds</li> <li>– collaborative opportunities across UK</li> </ul>            | <p>High</p> <ul style="list-style-type: none"> <li>– collaborative opportunities across UK</li> </ul>   |
| <b>Improve employee / pensioner experience</b>         | <p>High</p> <ul style="list-style-type: none"> <li>– local access maintained, including face-to-face service</li> </ul>   | <p>High</p> <ul style="list-style-type: none"> <li>– local access maintained, including face-to-face service</li> <li>– shared communications events</li> </ul>   | <p>Medium</p> <ul style="list-style-type: none"> <li>– dilution of local access</li> <li>– shared communication events</li> </ul>                                      | <p>Medium</p> <ul style="list-style-type: none"> <li>– dilution of local access</li> <li>shared communication events</li> </ul>   |

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|--|--|--|--|--|
| <p><b>Comply with sound governance arrangements and stewardship controls</b></p> | <p>Medium</p> <ul style="list-style-type: none"> <li>- Currently dependent on each Funds interpretation and application of governance arrangements.</li> <li>- Local accountability is maintained</li> </ul> | <p>High</p> <ul style="list-style-type: none"> <li>- Shared resources for governance, interpretation and further opportunity to expand the existing collaboration arrangements in respect of 'Internal Dispute Resolution Procedure' and Discretions Panel.</li> <li>- Local accountability is maintained</li> </ul> | <p>High</p> <ul style="list-style-type: none"> <li>- More consistent approach to Governance</li> <li>- Local accountability diluted</li> </ul>   | <p>High</p> <ul style="list-style-type: none"> <li>- More consistent approach to Governance</li> <li>- Local accountability diluted</li> </ul>                           |
| <p><b>Better information for better decisions</b></p>                            | <p>Network of information already available, LGA, CLG, etc. Collaboration with other pension officers through All Wales POG and other user groups</p>  | <p>Network of information already available, LGA, CLG, etc. Collaboration with other pension officers through All Wales POG and other user groups</p>  | <p>Network of information already available, LGA, CLG, etc. Collaboration may be required with English Funds due to the reduction in the number of Welsh Funds to interpret pension legislation.</p> | <p>Network of information already available, LGA, CLG, etc. A single welsh Fund will be required to collaborate with English Funds to interpret pension legislation.</p> |

## Proposed Next Steps

This report is regarded as being “Interim”

One of the most important perspectives still to be factored into the narrative, findings and initial conclusions are the views of our wider stakeholders. This element was always regarded as being essential in any final proposals. It is however easier to provide constructive comment upon a set of definite propositions and so this report in its current guise provides that opportunity. This report is therefore now being circulated for wider consultation and to invite comments on the findings. The following sets out the broad approach.

### Why is information being communicated?

This is critical. The report as drafted provides interim conclusions and recommendations. The consultation invites views on the conclusions reached and includes specific questions based on the direction of the report. We are inviting specific responses, together with the opportunity to make more general comment. This gives more focus for consultation rather than a wide ranging general discussion.

### What is being communicated?

4 separate documents have been prepared:

- i) The Full Report (excluding background research papers and analysis)
- ii) An executive summary
- iii) A short briefing or context note that may be used for wider communication purposes
- iv) An invitation to provide comments and views on the findings of the report together with a set of specific questions on which we are seeking consultation responses.

The production and completion of the draft Report is the end of one phase but also the start of another. This next phase is important in giving the conclusions ultimately reached wider credibility and so it is important that the consultation involves an approach that is clear and consistent and that the mechanisms to be used for wider engagement and consultation are effective in allowing all stakeholders the opportunity to comment.

### How and When?

The consultation process and how to respond

|  |  |
|--|--|
| <b>Scope of the consultation Topic of this consultation:</b> | Proposals relating to the optimal number of LGPS funds in Wales and the most appropriate organisational structure  |
| <b>Scope of this consultation:</b>                           | This consultation seeks responses from interested parties, including officers and councillors and their representative bodies, together with any wider interests |
| <b>Geographical scope:</b>                                   | Wales  |
| <b>Body responsible for the consultation:</b>                | The Society of Welsh Treasurers (Pensions Sub Group) is responsible for the draft report and the consultation exercise.  |

|                              |   |
|------------------------------|---|
| <b>Duration:</b>             | One calendar month. (From 1 <sup>st</sup> March 2013 to 31 <sup>st</sup> March 2013).   |
| <b>Consultation Bodies :</b> | <p>This consultation is seeking views from the following parties with an interest in the Local Government Pension Scheme in Wales:</p> <p>LGPS Administering Authorities in Wales and those charged with Governance of those Funds</p> <p>The Chief Executives of County and County Borough Councils in Wales</p> <p>Fire and Rescue Authorities in Wales</p> <p>Police and Crime Commissioners in Wales</p> <p>National Probation Service in Wales</p> <p>Other scheduled and admitted bodies to the LGPS Funds in Wales</p> <p>GMB</p> <p>UNISON</p> <p>Unite</p> <p>Welsh Government</p> <p>Department of Communities and Local Government</p> <p>Welsh Local Government Association (WLGA)</p> <p>CIPFA in Wales</p> <p>Association of Consulting Actuaries</p> |
| <b>How to respond</b>        | <p>You should respond to this consultation by 31<sup>st</sup> March 2013. You can respond by going to the hyperlink included in the covering correspondence associated with this report.</p> <p>This link will open from 1<sup>st</sup> March 2013.</p> <p>Alternately you can write to:</p> <p>WELSH LOCAL GOVERNMENT PENSION FUNDS-<br/>WORKING TOGETHER<br/>c/o WLGA Data Unit<br/>3-7 Columbus Walk<br/>Cardiff, CF10 4SD</p> <p>When responding, please state whether you are responding as an individual or representing the views of an organisation.</p>  |