Lancashire County Council

Pension Fund Committee

Friday, 6th June, 2014 at 10.00 am in Cabinet Room 'C' - County Hall, Preston

Agenda

Part 1 (Open to Press and Public)

No. Item

1. Apologies

2. Constitution: Chair and Deputy Chair; Membership; Terms of Reference (Pages 1 - 8)

3. Disclosure of Pecuniary and Non-Pecuniary Interests

Members are asked to consider any Pecuniary and Non-Pecuniary Interests they may have to disclose to the meeting in relation to matters under consideration on the Agenda.

4. Minutes of the Meeting held on 27 March 2014 (Pages 9 - 16)

To be confirmed, and signed by the chair.

5. Exclusion of Press and Public

The Committee is asked to consider whether, under Section 100A(4) of the Local Government Act, 1972, it considers that the public should be excluded from the meeting during consideration of the following items of business on the grounds that there would be a likely disclosure of exempt information as defined in the appropriate paragraph of Part 1 of Schedule 12A to the Local Government Act, 1972, as indicated against the heading to the item.

Part II (Not open to Press and Public)

6. Investment Performance Report (Pages 17 - 28)

(Not for Publication – Exempt information as defined in Paragraph 3 of Part 1 of Schedule 12A to the Local Government Act, 1972. It is considered that in all the circumstances of the case the public interest in maintaining the exemption outweighs the public interests in disclosing the information).

Lancashire County Council

7. Investment Panel Report (Pages 29 - 42)

(Not for Publication – Exempt information as defined in Paragraph 3 of Part 1 of Schedule 12A to the Local Government Act, 1972. It is considered that in all the circumstances of the case the public interest in maintaining the exemption outweighs the public interests in disclosing the information).

Part I (Open to Press and Public)

8. Consultation on Opportunities for Collaboration, Cost Savings and Efficiencies within the Local Government Pension Scheme (Pages 43 - 202)

9. Lancashire County Pension Fund - Annual Governance Statement 2013/14 (Pages 203 - 216)

10. Your Pension Service - Annual Administration Report (Pages 217 - 226)

11. Shareholder voting and engagement report (Pages 227 - 258)

12. Internal Audit Annual Report 2013/14, including the Audit Plan 2014/15 (Pages 259 - 272)

13. Urgent Business

An item of urgent business may only be considered under this heading where, by reason of special circumstances to be recorded in the Minutes, the Chair of the meeting is of the opinion that the item should be considered at the meeting as a matter of urgency. Wherever possible, the Chief Executive should be given advance warning of any Member's intention to raise a matter under this heading.

14. Date of Next Meeting

The next meeting of the Committee will be held on Friday 5 September 2014 at 10.00 a.m. at County Hall, Preston.

I M Fisher
County Secretary and Solicitor

County Hall
Preston

Pension Fund Committee
Meeting to be held on 6 June 2014

Electoral Division affected: None

Constitution: Chair, Deputy Chair and Terms of Reference

Contact for further information:
Chris Mather, 01772 533559, Office of the Chief Executive,
Chris.mather@lancashire.gov.uk

Executive Summary and Recommendation

The Committee is asked to note:

i. the appointment of County Councillors T Burns and M Parkinson as Chair and Deputy Chair respectively of the Pension Fund Committee for the 2014/15 municipal year.

ii. the appointment of County Councillors M Parkinson and T Burns as Chair and Deputy Chair respectively of the Pension Fund Administration Sub-Committee for the 2014/15 municipal year

iii. the membership of the Pension Fund Committee and the Pension Fund Administration Sub-Committee.

iv. the Terms of Reference of the Pension Fund Committee and the Pension Fund Administration Sub-Committee.

Background

1. Pension Fund Committee

The County Council at its annual meeting on 15 May 2014 agreed that the Pension Fund Committee shall comprise 14 County Councillors (on the basis of 6 Labour members, 6 Conservative members, 1 Liberal Democrat member and 1 Independent member) and 7 co-opted voting members.

The following County Councillors have subsequently been nominated to serve on the Pension Fund Committee for the following year:

County Councillors (14):

L Beavers
T Burns
D Borrow
M Brindle
J Oakes
M Parkinson
A Schofield
K Sedgewick

Lancashire County Council

G Dowding	D Stansfield
J Gibson	V Taylor
K Iddon	D Westley

The following voting co-optees have been nominated to serve on the Committee:

Voting co-opted members (7)

Lancashire Unitary Authorities:

Councillor M Smith (Blackpool Council)
Vacancy (Blackburn with Darwen Borough Council)

Lancashire District Councils:

Councillor P Leadbetter (Chorley Borough Council)
Vacancy

Trade Union representatives:

Mr B Harvey
Mr R Whittle

Higher Education/Further Education establishments:

J McCann

The Full Council appointed County Councillor T Burns and County Councillor M Parkinson as Chair and Deputy Chair of the Pension Fund Committee for the 2014/15 municipal year.

A copy of the Committee's Terms of Reference are attached at Appendix 'A'.

2. Pension Fund Administration Sub-Committee

The County Council at its annual meeting on 15 May 2014 agreed that the Pension Fund Administration Sub-Committee shall comprise 5 County Councillors (on the basis of 2 Labour members, 2 Conservative members and 1 Liberal Democrat member) and 2 co-opted voting members.

The following County Councillors have subsequently been nominated to serve on the Pension Fund Administration Sub-Committee for the following year:

County Councillors (5):

M Brindle	A Schofield
T Burns	D Westley
M Parkinson	

The following voting co-optees have been nominated to serve on the Pension Fund Administration Sub-Committee:

Voting co-opted members (2)

Councillor M Smith (Blackpool Council)
Mr B Harvey (Trade Union representative)

The Full Council appointed County Councillor M Parkinson and County Councillor T Burns as Chair and Deputy Chair of the Pension Fund Administration Sub-Committee for the 2014/15 municipal year.

A copy of the Sub-Committee's Terms of Reference are attached at Appendix 'B'.

Consultations

N/A

Implications:

This item has the following implications, as indicated:

Risk Management

No significant risks have been identified.

Local Government (Access to Information) Act 1985
List of Background Papers

Paper	Date	Contact/Directorate/Tel

N/A

Reason for inclusion in Part II, if appropriate

N/A

Appendix 'A'

Pension Fund Committee

Composition and role

1. The Pension Fund Committee ("the Committee") comprises fourteen County Councillors and seven voting co-optees representing the following organisations:

    a. One co-optee representing the Further and Higher Education sector in Lancashire;
    b. One co-optee from Blackburn with Darwen Council;
    c. One co-optee from Blackpool Council;
    d. Two co-optees representing Trade Unions; and
    e. Two co-optees representing the Lancashire borough and city councils.

2. The role of the Committee is to:

    a. exercise responsibility for the administration of the Lancashire County Pension Fund ("the Fund");
    b. establish policies in relation to investment management, which shall include meeting with the Investment Panel to consider future investment policy for the Fund;
    c. monitor and review investment activity and the performance of the Fund; and
    d. present an annual report to the Full Council on the state of the Fund and on the investment activities during the preceding year.

3. Meetings of the Committee shall be open to the public, but the public may be excluded where information of an exempt or confidential nature is being discussed – see Access to Information Procedure Rules set out at Appendix 'H' to the County Council's Constitution.

Terms of Reference

1. To exercise Lancashire County Council's responsibility for the management of the Fund, including the administration of benefits and strategic management of Fund assets and liabilities.

2. To have overall responsibility for investment policy and monitor overall performance.

3. To submit an annual report to the Full Council on the performance and state of the Fund and on the investment activities during the year.

4. To appoint a minimum of two suitable persons to an Investment Panel through a sub committee convened for that purpose.

5. To meet at least quarterly, or otherwise as necessary, with the Investment Panel in attendance.

6. To review governance arrangements and the efficient and effective use of external advisors to ensure good decision-making.

7. To approve the policies and procedures for any internally managed Fund investments.

8. To establish a Pension Fund Administration Sub-Committee and agree its composition, role and terms of reference.

9. To receive regular reports from the Treasurer to the Fund on the administration of the Fund to ensure that best practice standards are satisfied and met and to satisfy itself that and justify to all stakeholders, including Fund Employers, that the Fund is being run on an efficient and effective basis.

10. To approve the procurement process, tender award criteria and evaluation methodology in advance of any tender being invited for the appointment of external advisers and other external assistance in relation to the management of the Fund, to include:

    a. external Investment Managers to discharge functions to be determined by the Committee relating to the management of the Fund’s investments;
    b. external property agents and advisors;
    c. an external corporate governance adviser;
    d. an external Fund custodian;
    e. external performance measurement advisers;
    f. the Fund Actuary; and
    g. the Fund’s AVC Provider.

11. To approve an Annual Business Plan, Statement of Investment Principles, Governance Policy Statement , Treasury Management Strategy and Policy and Governance Compliance Statement.

12. To approve the Pension Fund Annual Report.

13. To approve a Funding Strategy statement to include the Fund's policy in respect of:

    a. the Funding Target;
    b. the collection of employee contributions;
    c. the collection of employer contributions;
    d. the collection of additional employer contributions; and
    e. Admissions and Terminations.

14. To determine which pension related functions and responsibilities should be exercised under the Council's Scheme of Delegation to Chief Officers.

15. To approve the overall appropriate and necessary training requirements for members of the Committee.

Appendix 'B'

Pension Fund Administration Sub-Committee

Composition and role

1. The role of the Pension Fund Administration Sub-Committee ("the Sub-Committee") is to ensure that best practice standards are satisfied and met and to satisfy itself that and justify to all stakeholders, including Fund Employers, that the Fund is being run on an efficient and effective basis.

2. The Sub-Committee shall meet at least twice a year or otherwise as necessary.

3. The membership of the Sub-Committee shall be determined by the Pension Fund Committee ("the Committee"). The current membership is five County Councillors, one Trade Union representative and one representative from either the Lancashire borough and city councils or the Lancashire Unitary Authorities. All members have voting rights.

Terms of Reference

1. To ensure that the Committee’s functions as Administering Authority are discharged and approve an Annual Administration Report.

2. To agree the terms of a Service Level Agreement in relation to the provision of administration services and support.

3. To submit reports and make recommendations to the Committee relating to the administration of the Lancashire County Pension Fund.

4. To respond to any Government consultations relating to the administration and benefits of the Local Government Pension Scheme.

5. To approve the following:

    a. Pensions Administration strategy statement;
    b. Communication Policy statement;
    c. Internal Dispute Resolution procedure;
    d. Death Grant procedure;
    e. Bulk Transfer Payment policy;
    f. Commutation policy (small pensions);
    g. Transfer policy; and
    h. Abatement policy.

Lancashire County Council

Pension Fund Committee

Minutes of the Meeting held on Thursday, 27th March, 2014 at 10.00 am in Cabinet Room 'C' - The Duke of Lancaster Room, County Hall, Preston

Present:

County Councillor Terry Burns (Chair)

County Councillors

L Beavers	K Sedgewick
M Brindle	R Shewan
G Dowding	D Stansfield
K Iddon	V Taylor
J Oakes	D Westley
M Parkinson	B Yates

Co-opted members

Bob Harvey, (Trade Union representative)
Councillor Mark Smith, (Blackpool Council representative)
Ron Whittle, (Trade Union representative)

County Councillors R Shewan and B Yates replaced County Councillors J Gibson and A Schofield at this meeting.

Eric Lambert and Noel Mills, Independent Advisers to the Pension Fund were also present.

Announcements

The Committee stood in silent tribute to Councillor Dorothy Walsh who passed away in February 2014. It was noted that Councillor Walsh had represented Blackburn with Darwen Borough Council on the Lancashire Pension Fund Committee since September 2011.

1. Apologies

Apologies for absence were received from County Councillors D Borrow, Councillor I Grant and Councillor P Leadbetter.

2. Disclosure of Pecuniary and Non-Pecuniary Interests

County Councillor D Westley declared a pecuniary interest in agenda item 9 (Transaction of Urgent Business) as a former employee of the organisation

referred to in the report. He was also in receipt of a pension from the organisation.

3. Minutes of the Meeting held on 29 November 2013

The Minutes of the Meeting held on 29 November 2013 were presented.

Resolved: That the Minutes of the meeting held on 29 November 2013 be confirmed and signed by the chair.

4. Urgent Business

None.

5. Date of Next Meeting

It was noted that the next meeting of the Committee would be held on Friday 6 June 2014 at 10.00 a.m. at County Hall, Preston.

6. Exclusion of Press and Public

Resolved: That the press and members of the public be excluded from the meeting during consideration of the following items of business on the grounds that there would be a likely disclosure of exempt information as defined in the paragraph of Part 1 of schedule 12A to the Local Government Act, 1972, indicated against the heading to the item. It was considered that in all the circumstances the public interest in maintaining the exemption outweighed the public interest in disclosing the information.

7. Quarterly Investment Performance Report

(Exempt information as defined in Paragraph 3 of Part 1 of Schedule 12A to the Local Government Act, 1972. It was considered that in all the circumstances of the case the public interest in maintaining the exemption outweighed the public interest in disclosing the information)

The Committee considered a report on the performance of the Fund as at 31 December 2013, focussing on the key areas of:

- the funding position;
- cash flow;
- fund investment performance;
- management performance;
- investment allocations; and
- risk management of the Fund including credit, liquidity, investment and operational risks.

Resolved: That the report be noted.

8. Investment Panel Report

(Exempt information as defined in Paragraph 3 of Part 1 of Schedule 12A to the Local Government Act, 1972. It was considered that in all the circumstances of the case the public interest in maintaining the exemption outweighed the public interest in disclosing the information)

The Committee received a report from the Investment Panel setting out the work of the Panel at its meeting held on 29 November 2013. The Committee's attention was specifically drawn to the following key areas:

- The Investment Context in which the Fund was operating;
- Fund Performance, Risk and Allocations;
- Investment Decisions and
- Further Allocations

Resolved: That the report be noted.

9. Transaction of Urgent Business

(Exempt information as defined in Paragraph 3 of Part 1 of Schedule 12A to the Local Government Act, 1972. It was considered that in all the circumstances of the case the public interest in maintaining the exemption outweighed the public interest in disclosing the information)

County Councillor D Westley withdrew from the meeting during consideration of this item.

The Committee received details of an item that had been dealt with under the procedure for dealing with matters of Urgent Business.

Resolved: That the report be noted.

The Committee then returned to the remaining Part I agenda items.

10. Report of the Pension Fund Administration Sub-Committee

The Committee considered a report on the meeting of the Administration Sub-Committee held on 12 March 2014.

The minutes of the meeting were presented and the Committee's attention was drawn to the following matters:

1. Public Sector Pension Reform – Changes to the Local Government Pension Scheme as from 1 April 2014

The changes represented the biggest change to Public Sector pension provision in recent memory and had necessitated significant amendments to the Fund's administration systems and processes. A comprehensive communication campaign to inform employers and scheme members had been underway since 2013.

The Sub-Committee approved revisions to the Pensions Administration Strategy Statement, and the revised Communication Policy Statement.

The Government had just announced that no new Councillors would be eligible to join the LGPS from 1 April 2014. Councillors who were members of the Scheme on 31 March 2014 would be able to continue as members of the Scheme but only until the end of the term of office they were in on 1 April 2014.

2. The Payment of Death Grants

The Sub-Committee approved revised procedures in respect of the payment of death grants. The changes were intended to simplify the procedure, to allow the family of the deceased to exercise some autonomy and to give them the option to appoint an independent trustee.

3. Changes to the County Council's partnership with BT - Your Pension Service

The Sub-Committee had welcomed the decision by the County Council to return Your Pension Service to the County Council following changes to the Council's partnership with BT.

Resolved: That the minutes of the Pension Fund Administration Sub-Committee meeting held on 12 March 2014 be noted.

11. Notice of Motion Relating to Socially Responsible Investment Agreed by the County Council

The Committee considered a report on proposals to commission advice in relation to various issues relating to the broader social and environmental impacts of the Pension Fund's investment activities.

Members were informed that the proposal was in response to the Notice of Motion carried by Full Council on 12 December 2013. The Notice of Motion asked officers to undertake work aimed at examining potential routes to increase the level of environmental and social responsibility of invested companies and to examine the barriers to a policy of active disinvestment in areas which would appear to be in conflict with the County Council's broader policy agenda.

Officers had considered the options available to the Fund and it was proposed to utilise a generalist consultant from the Fund's consultancy framework to undertake the piece of work. Several concerns were expressed about the wide reaching piece of work that would need to be undertaken and the significant cost

that would have to be met by the Fund. Following a lengthy discussion it was suggested that the Committee establish a small task and finish group to review the scope of the project and to undertake the work. The task and finish group would aim to report back in autumn 2014 by which time other work in the same space being undertaken by the LGPS Shadow Advisory Board was likely to have produced some conclusions which could be looked at alongside the specific work being undertaken by the Fund.

Resolved:

i. That a small task and finish group be established to review, and amend as necessary, the scope of the Notice of Motion as agreed by the Full Council on 12 December 2013 in relation to environmentally and socially responsible investment by the Fund.

ii. That following i. above, the task and finish group be requested to present a report to the Committee in Autumn 2014 setting out any issues or recommendations in relation to the social and environmental impacts of the Fund's investment strategy and activities.

12. Funding Strategy Statement and Statement of Investment Principles

The Committee considered a report on the Fund's revised Funding Strategy Statement. This followed the results of the 2013 formal actuarial valuation of the Fund as noted by the Committee at its meeting of 29 November 2013.

It was noted that the revised Funding Strategy Statement incorporated the requirements set out in the Fund's Statement of Investment Principles, which itself had been updated to reflect the changes to specific investment strategies relating to particular asset classes, previously approved by the Committee.

Resolved:

i. That the revised Funding Strategy Statement, as set out at Appendix 'A', be approved.

ii. That the revised Statement of Investment Principles, as set out at Appendix 'B', be approved.

13. Lancashire County Pension Fund Risk Register

The Committee considered a report on the establishment of a Lancashire County Pension Fund Risk Register.

It was noted that the County Council as administering authority of Lancashire County Pension Fund had responsibility for ensuring that there was effective risk management in place in relation to the operations of the Fund. This requirement was reflected in both the investment regulations and guidance issued by the Chartered Institute of Public Finance and Accountancy (CIPFA).

Accordingly, a risk register had been produced to systematically identify, assess, and evaluate the risks faced by the Pension Fund, and to consider the current and future mitigating controls that might be required to manage these risks effectively.

Risk owners would be required to manage the risks for which they were responsible and the risk register would be updated periodically as a result. Updates would be reported to the Pension Fund Committee on a regular basis, and at least annually.

Members agreed that future reporting of the Risk Register should prioritise the identified risks with the highest risks being brought to the attention of the Committee. Any new risks and significant changes would also be brought to the Committee's attention.

It was reported that a risk and liability strategy would also be presented to a future meeting.

Resolved: That the Lancashire County Pension Fund Risk Register, as presented at Appendix 'A', be approved.

14. Shareholder Voting, Engagement, and Fiduciary Duty

The Committee considered a comprehensive report on the Fund's shareholder voting arrangements and activity, and engagement activity for the period 1 October to 31 December 2013.

The Committee was informed that Pensions and Investment Research Consultants Ltd (PIRC) act as the Fund's proxy and cast the Fund's votes on its investments at company shareholder meetings. PIRC were instructed to vote in accordance with their guidelines unless the Fund instructed otherwise.

It was noted that the Fund had voted on 274 occasions during this period and had opposed or abstained in 34% of votes.

It was also noted that details of holdings of the Pension Fund in relation to meetings held in this period had been included in the report to provide
More contextual information regarding the geographical and sector spread of the shareholder interests. The Committee welcomed this information and asked officers to consider the inclusion of voting results in future reports.

Resolved: That the report be noted.

15. External Audit
Lancashire County Pension Fund Audit Plan 2013/14

The Committee considered the External Audit Plan and fees for the audit of the Lancashire County Pension Fund for 2013/14.

It was noted that the Audit Plan would also be presented to the Council's Audit and Governance Committee on 31 March 2014.

Resolved: That External Audit plan and fees for the audit of the Lancashire County Pension Fund for 2013/14 be noted.

16. External Audit
Lancashire County Pension Fund Governance Benchmarking Report

The Committee considered a national report produced by Grant Thornton UK LLP on the governance arrangements in place for Local Government Pension Schemes.

It was noted that an individual benchmarking report had also been produced to show how the Lancashire County Pension Fund compared with others across key indicators of good governance.

Resolved: That the report be noted.

I M Fisher
County Secretary and Solicitor

County Hall
Preston

Agenda Item 6

(NOT FOR PUBLICATION: By virtue of paragraph(s) 3 of Part 1 of Schedule 12A of the Local Government Act 1972. It is considered that all the circumstances of the case the public interest in maintaining the exemption outweighs the public interest in disclosing the information)

Document is Restricted

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Document is Restricted

Pension Fund Committee
Meeting to be held on 6 June 2014

Electoral Division affected:
None

Consultation on Opportunities for Collaboration, Cost Savings and Efficiencies within the Local Government Pension Scheme
(Appendices 'A', 'B' and 'C' refer)

Contact for further information:
George Graham, (01772) 538102, County Treasurer's Directorate
george.graham@lancashire.gov.uk

Executive Summary

On 1st May 2014 the Department for Communities and Local Government (CLG) published their proposals for structural changes to the Local Government Pension Scheme. This follows the "call for evidence" of last summer and the completion of research into various options by Hymans Robertson. These proposals are subject to consultation which closes on 11th July.

In summary, the consultation document proposes a major change in the management of the assets held by individual LGPS. The rationale behind the proposals is to drive out significant savings in investment management fees across the LGPS by creating two large pools of assets, known as Common Investment Vehicles (CIVs). One CIV would be for listed investments (stocks and shares) and the other for alternative assets, including Private Equity.

Within the CIV for listed investments, it is proposed by the CLG that LGPS funds move from active management to the passive management of assets. It is CLG's view that this framework allows accountability for investment strategy to be retained locally whilst maximising the achievement of economies of scale.

The proposals raise a number of significant issues and given the timing of publication and the timescale for completing reports to this meeting of the Committee it has not been possible to produce a complete response. However, this report sets out an initial overview which forms the basis of a response on behalf of the Committee and which can be finalised by officers in consultation with the Chair.

Recommendation

The Committee is recommended to:

1. Approve the framework for a response to the Government's Consultation Document as set out in the body of this report.

2. Authorise the County Treasurer, as Treasurer to the Fund, in consultation with the Chair to finalise the Fund's detailed evidence based response.

Lancashire County Council

Background and Advice

Last summer CLG issued a "call for evidence" in relation to structural reform of the Local Government Pension Scheme (LGPS). The options floated as part of this process included fund mergers, pooling of assets and increased collaboration between the 89 LGPS funds in England and Wales. Following the closure of the initial call for evidence CLG and the Cabinet Office commissioned research into a number of options from Hymans Robertson one of the large actuarially based consultancies with a presence in the LGPS marketplace.

On 1st May CLG published three documents, which are attached at Appendices A to C of this report:

- Their summary of the response to the Call for Evidence and their views on the points raised
- The Hymans Robertson Research
- A consultation document setting out their proposals for change.

Key Headlines of the Consultation

The key headlines from these various documents are that:

- Fund mergers (other than on a voluntary basis) are off the table as they raise a range of specific complexities and dilute local accountability;

- While CLG believe there is scope for changes in scheme administration in order to make savings, any proposals should wait until the transition to the new LGPS 2014 has been completed;

- Fundamental changes to the approach to investment across the LGPS. CLG believe there is scope to make savings nationally of around £0.6bn in investment management fees through a form of asset pooling which would see a move to passive management for listed investments and away from "fund of funds" investments in alternative asset classes, while at the same time leaving the determination of investment strategy at a local level. This proposal is predicated on the assumption that appropriate investment returns can be generated through the passive management of listed investments.

  Whilst the consultation paper does not go as far as setting out explicitly that this would be mandatory, it is a clear assumption within the consultation that Funds will be expected to comply.

  Further information is set out in the consultation paper attached to this report.

Overall Initial View

In essence these proposals have the appearance of "nationalising" the assets of the LGPS and setting the overall investment approach at a national level through a requirement to use two or more large pooled vehicles (known as Common Investment Vehicles, or CIVs), the constitution and accountability mechanisms for

which are currently unclear. In essence, this would give each LGPS the choice as to the proportion of its investments to go within each CIV.

This appears to seek to manage the LGPS in aggregate through a form of one size fits all approach to the investment of fund assets. The approach is simplistic, and ignores the key fact that administering authorities have a fiduciary duty regarding the payment of pension promises, and have a duty and a responsibility for making decisions in relation to investment strategy in the context not just of asset performance but also of the liabilities of individual funds. These responsibilities have led to individual funds developing their own specific approaches to asset management in order to maximise investment return:

- Some funds manage a very high proportion of assets in house, in general these funds can demonstrate better than average performance, particularly where this has been done over the long term and with a high level of consistency;
- Other funds in effect delegate investment decision making to a consultancy firm (usually but not exclusively an actuarially based firm) who in effect act as what in the relevant jargon is called a fiduciary manager;
- Clearly there are then various combinations of these two extremes.

Over the period since 2009 the Lancashire County Pension Fund has been engaged in a strategic move to develop a higher performing investment strategy, which has been made possible by acquiring professional investment skill and undertaking a greater degree of in house management, although not going as far as actually running an in house trading operation (other than for a very small bond portfolio). This has resulted in the Fund being able to move to a strategy of an asset allocation focussed on reducing volatility and which is alive to the characteristics of the fund's liabilities. Liabilities are a critical element within this, as movements in the Fund's liabilities have had the greatest impact on the level of funding.

This approach has enabled the LCPF to invest significant sums in infrastructure projects on favourable terms and to access a range of different forms of investment which achieve the Fund's investment objectives.

It is clear that the change in investment strategy has improved the Fund's performance, and the Fund's developing approach to liability management seeks to build on this further.

However, the proposals made of CLG appear to reflect a paucity of ambition for LGPS as a whole. Rather than seeking to improve investment performance across LGPS to that of the best performers, instead CLG are proposing a lowest common denominator investment strategy. Of greatest concern is the explicit assumption that passive management of listed equities is the most appropriate means of securing an investment return which will enable the Fund to meet its liabilities. Given the importance of this, it is very concerning that the evidence presented by the CLG to support this move appears to have significant gaps and makes assumptions around investment performance without clear evidence to support the conclusions drawn.

From the consultation paper it would appear that the Fund's investment strategy decisions would be broad asset allocations between two CIV asset pools. This removes the independence of the individual funds which will remain constitutionally

independent and responsible for addressing deficits and liabilities, although with little ability to utilise funds' assets in this regard. However, there is very little actual information contained in what has been published by the Government on how the proposals would work in practice. What is clear is an underlying view that some degree of compulsion will sit behind the move to new arrangements.

Specific Consultation Questions

The CLG consultation document asks 5 specific questions and seeks evidence based responses. Given the time available to prepare this report it has not been possible to construct a complete fully evidenced response. Therefore what follows is in essence a "heads of terms" for a full response which if the Committee agree to the content of this report will be signed off by the Treasurer in consultation with the chair.

Question 1

Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Please explain and evidence your view.

It is certainly the case that by pooling assets it will be possible to reduce fees, particularly if a passive management approach to listed assets is adopted. However, what is important is not the level of fees themselves but the level of investment return achieved after the payment of fees. Different asset classes, and options for investment within those classes provide access to differing levels of returns taking into account the level of risk funds are prepared to take and the degree of volatility to which they wish to be exposed.

It is the view of the Fund's officers that the adoption of an approach which forces LGPFs to invest in passive management significantly increases the risk of a reduced investment performance. It may also (depending on the nature of its current portfolio construction) increase a Fund's exposure to equity market volatility which in combination with the valuation of liabilities has been the key factor impacting on the scale of fund deficits in the LGPS.

CIV's are one means of creating economies of scale. An alternative would be to capitalise on the centres of expertise in investment management that already exist within LGPS positively building on strength rather than creating something new, with the attendant disruption and uncertainty. Such arrangements need not lead to mergers and need not even be formal shared services simply the pooling of resources to manage assets.

There is a significant risk that through concentrating LGPS assets in this way particularly in a passive format that the assets will become perfectly correlated with the overall market in a way that is not the case in the current arrangements which are significantly diversified. This creates a new systemic risk in relation to LGPS which is a risk to the Treasury as it increases the chances that the implicit state guarantee to LGPS is called upon. This factor seems to have been ignored in the development of CLG's proposals.

Question 2
Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?

We would entirely agree that asset allocation decisions must remain local, but this does not appear to be what is proposed. The decisions in relation to asset allocation being left to Administering Authorities appear to be around the balance between two Collective Investment Vehicles, one for listed assets and one for alternatives.

Funds should have to demonstrate that they employ the relevant expertise to make appropriate, individually tailored asset allocation decisions, thereby increasing local accountability and diversification of the LGPS investment universe as a whole, which is a means of reducing the systemic risk created by greater asset concentration. This also allows funds to manage and allocate their assets in a way alive to the particular characteristics of their liabilities.

As the proposals stand aaccountability and responsibility for poor performance are separated and it is not clear how local funds will be able to sack a non performing manager. Currently stakeholders within funds are able to and do engage with those responsible for managing funds around the nature of and success of investment strategies and not just asset allocation as they have a direct stake in success. This will not be possible in the proposed model significantly diluting accountability to the wider group of fund stakeholders including local taxpayers.

The proposals also detach funds assets from their liabilities and would seem to make it virtually impossible to use assets in a way which is aware of the behaviour of liabilities and hence make a contribution to reducing deficits. We are not aware of any other funded pension scheme where this is the case.

We would suggest that either funds should be required to employ their own staff with sufficient investment expertise or to club together with another fund that does (or in order to do so). The investment approach for individual funds needs to be closely aligned with a liability management strategy individually tailored for each fund. This approach would deliver economies of scale in cost terms as larger investment pools, even with assets remaining segregated would have better bargaining power. This would build on the evidence that greater professionalism of in-house teams drives investment performance, and combined with the approach to liability management tackles the thorny issue of deficit reduction as well as reducing systemic risks to the LGPS as a whole.

Question 3
How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles

The answer here requires much further development but a sufficient number would be required to reflect each individual type of investment (e.g. UK equity, small cap companies etc). This is to ensure that it is possible for funds to move away from a non performing asset pool and for there still to be competition, even if no choice exists on the source of investment. It is likely that this would require several hundred individual asset types within the CIV wrappers.

Question 4

What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?

The Fund's Officers are concerned that the approach of a common investment vehicle does not offer a beneficial structure, and that alternatives would provide more improved outcomes for LGPFs. There is significant concern that the proposed disaggregation between responsibility and accountability for fund performance runs contrary to the principles of effective governance for individual LGPFs, and would effectively undermine governance arrangements.

Question 5
In the light of the evidence on the relative costs and benefits of active and passive management including Hymans Robertson's evidence on aggregate performance which of the options set out above offers the best value for tax payers, scheme members, and employers?

The options set out in the consultation paper are as follows:

(i) Funds could be required to move all listed assets into passive management, in order to maximise the savings achieved by the Scheme.

(ii) Alternatively, funds could be required to invest a specified percentage of their listed assets passively; or to progressively increase their passive investments.

(iii) Fund authorities could be required to manage listed assets passively on a "comply or explain" basis.

(iv) Funds could simply be expected to consider the benefits of passively managed listed assets, in the light of the evidence set out in this paper and the Hymans Robertson report

The third and fourth options could be supported. These are the only options that allow the different starting points of individual funds to be recognised and those with more sophisticated and liability aware investment strategies to build on success, whilst clearly setting out the benefits of the investment approach taken.

Elected councillors exercise the same responsibilities in LGPS as trustees do in private sector schemes although without the formal status. Any option save the fourth removes their independence to take action in the best interests of the fund for which they are responsible.

Consultations
Following agreement of the broad framework of this response further discussions will take place with fund managers and other stakeholders in order to ensure the final response includes an appropriate evidence base.

Implications:
This item has the following implications, as indicated:

Risk management
The publication of these proposals by the Government creates a number of risks in terms of market uncertainty with potentially some market participants being unwilling to deal with funds which might imminently lose control of their asset base. Similarly the uncertainty created may unsettle the various in house teams that exist across LGPS.

Currently these risks will have to be managed through maintaining both ongoing dialogue and continuing the focus on delivering the results of the agreed investment strategies**.**

Financial
The Government's proposals do have the potential to reduce costs. However, this is potentially at the expense of overall fund performance and increased exposure to equity market volatility as well as very significant transition costs. The final response will seek to quantify some of these issues and provide evidence to support this view..

Legal
It is wholly unclear what legal routes are open to the Government to implement some of their proposals, short of primary legislation, although this may become clear in coming weeks.

Local Government (Access to Information) Act 1985
List of Background Papers

Paper	Date	Contact/Directorate/Tel

Reason for inclusion in Part II, if appropriate

N/A

Department for Communities and Local Government

Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies

Consultation

May 2014
Department for Communities and Local Government

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1. The consultation process and how to respond

Scope of the consultation

Topic of this consultation:	The structure of the Local Government Pension Scheme and opportunities to reduce administration and investment management costs.
Scope of this consultation:	The consultation sets out the evidence for proposals for reforms to the Local Government Pension Scheme and opportunities to deliver savings of £660 million a year for local taxpayers. The Government seeks respondents' views on the proposals set out in section four, and asks respondents to consider how if adopted, these reforms might be implemented most effectively.
Geographical scope:	This consultation applies to England and Wales.
Impact Assessment:	It is not possible to provide an impact assessment at this stage as the detailed mechanism needed to implement the proposed reforms is still being developed.

Basic Information

To:	The consultation is aimed at all parties with an interest in the Local Government Pension Scheme and in particular those listed on the Government's website: https://www.gov.uk/government/publications/local-government-pension-scheme-regulations-information-on-who-should-be-consulted
Body/bodies responsible for the consultation:	Secretary of State, Department for Communities and Local Government. The consultation will be administered by the Workforce, Pay and Pensions division.
Duration:	The consultation will last for 10 weeks, opening on 1 May and closing on 11 July 2014.
Enquiries:	Enquires should be sent to Victoria Edwards. Please email LGPSReform@communities.gsi.gov.uk or call 0303 444 4057.
How to respond:	Responses to this consultation should be submitted to LGPSReform@communities.gsi.gov.uk by **11 July 2014**. Electronic responses are preferred. However, you can also write to: Victoria Edwards

	Department for Communities and Local Government Zone 5/F5, Eland House Bressenden Place London, SW1E 5DU Please state whether you are responding as an individual or representing the views of an organisation. If responding on behalf of an organisation, please give a summary of the people and organisations it represents and where relevant, who else you have consulted in reaching your conclusions.
After the consultation:	The responses to the consultation will be analysed and a Government response published. Should any legislative changes be needed, a further consultation will follow.
Agreement with the Consultation Principles:	This consultation has been drafted in accordance with the Consultation Principles.

Background

Getting to this stage:	This consultation has been developed drawing on three sources of evidence: • A call for evidence on the future structure of the Local Government Pension Scheme, which ran from 21 June to 27 September 2013. 133 responses were received and analysed, helping to inform this consultation. • An analysis of the responses to the call for evidence provided by the Shadow Scheme Advisory Board. • Supplementary cost-benefits analysis of proposals for reform commissioned from Hymans Robertson using the Contestable Policy Fund. The commission did not extend to making recommendations. The Shadow Board's analysis, the Hymans Robertson report and the Government's response to the call for evidence are all available on the Government's website: https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies.
Previous engagement:	As outlined above, this consultation follows a call for evidence that gave anyone with an interest in the Scheme the opportunity to inform the Government's thinking on potential structural reform. The call for evidence was run in conjunction with the Local Government Association and the responses were shared with the Shadow Scheme Advisory Board, which provided the Minister for Local Government with their recommendations and analysis of the responses. The call for evidence also drew on a round table event that took place on 16 May 2013 with representatives of administering

	authorities, employers, trade unions, the actuarial profession and academia. This event discussed the potential for increased co-operation within the Scheme, including the possibility of structural change to the existing 89 funds.

Additional copies

1.1 This consultation paper is available on the Government's website at: https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies

Confidentiality and data protection

1.2 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000, the Data Protection Act 1998 and the Environmental Information Regulations 2004).

1.3 If you want the information that you provide to be treated as confidential, please be aware that, under the Freedom of Information Act 2000, there is a statutory code of practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, in itself, be regarded as binding on the Department.

1.4 The Department will process your personal data in accordance with the Data Protection Act 1998 and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties. Individual responses will not be acknowledged unless specifically requested.

Help with queries

1.5 Questions about the policy issues raised in the document can be sent to LGPSReform@communities.gsi.gov.uk.

1.6 A copy of the Consultation Principles is at www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance. Are you satisfied that this consultation has followed these principles? If not or you have any other observations about how we can improve the process please email: consultationcoordinator@communities.gsi.gov.uk

1.7 Alternatively, you can write to:

DCLG Consultation Co-ordinator,
Zone 8/J6, Eland House,
Bressenden Place
London SW1E 5DU.

2. Introduction and background

Introduction

2.1 The Government believes that there is scope for significant savings, of £660 million per year, to be achieved through reform of the Local Government Pension Scheme. To that end, from 21 June to 27 September 2013, the Government ran a call for evidence on structural reform of the Local Government Pension Scheme. The paper asked respondents to consider what might be done to improve fund performance and drive efficiencies across the Scheme.

2.2 This consultation represents the next step in reform of the Scheme, building on the responses to the call for evidence and further cost benefit analysis of potential options for reform. It sets out the Government's preferred approach to reform and seeks views on the proposals.

Background

2.3 With assets of £178 billion in 2012-13, the Local Government Pension Scheme is one of the largest funded pension schemes in Europe. Several thousand employers participate in the Scheme, which has a total of 4.68 million active, deferred and pensioner members.[1] The Department for Communities and Local Government is responsible for the regulatory framework governing the Scheme in England and Wales.

2.4 The Scheme is managed through 89 funds which broadly correspond to the county councils following the 1974 local government reorganisation as well as each of the 33 London Boroughs. In most cases, the fund administering authorities are upper tier local authorities such as a county or unitary council, but there are also some administering authorities established specifically to manage their fund, for example the Environment Agency Pension Fund and the London Pension Fund Authority. The fund authorities have individual governance and working arrangements. Each fund has its own funding level, cash-flow and balance of active, deferred and pensioner members, which it takes into account when adopting its investment strategy, which is normally agreed by the councillors on the fund authority's pensions committee.

2.5 Employer contributions to the Scheme, the majority of which are funded by taxpayers, were more than £6 billion in 2012-13. The costs of managing and administering the scheme were estimated as being £536 million in 2012-13.[2] However, the actual costs are likely to be rather higher; the investment costs alone have recently been estimated as in excess of £790 million.[3] While investment returns and the costs of providing

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[1] Scheme asset value and membership figures taken from Department for Communities and Local Government statistical data set - Local government pension scheme funds summary data: 2012 to 2013 https://www.gov.uk/government/statistical-data-sets/local-government-pension-scheme-funds-summary-data-2012-to-2013

[2] Local government pension scheme funds summary data: 2012 to 2013

[3] Department for Communities and Local Government: Local Government Pension Scheme structure analysis, Hymans Robertson p.11. https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies

benefits are the most significant drivers of the overall financial position of funds, management costs also have an impact on funding levels and thus the pension contributions made by employers and scheme members.

2.6 Under the Public Service Pensions Act 2013, there will be a requirement for a national scheme advisory board, as well as a local board for each of the 89 funds. The regulations that will establish national and local governance arrangements have not yet been made and the Department will be consulting on these issues shortly. In the meantime, scheme employers and the trade unions have established a Shadow Board, which has been considering a number of issues connected with the Scheme, including its efficient management and administration. In addition, the Minister for Local Government has asked the Shadow Board to consider how the transparency of the funds might be improved.

Getting to this stage

2.7 In 2010, the Government commissioned Lord Hutton to chair the Independent Public Service Pensions Commission. The purpose of the Commission was to review public service pensions and to make recommendations on how they might be made more sustainable and affordable in the long term, while being fair to both taxpayers and public sector workers.

2.8 Lord Hutton's final report was published on 10 March 2011 and formed the basis for major reforms to all public service pension schemes. The new Local Government Pension Scheme which came into effect on 1 April 2014 is the first scheme to be introduced that follows Lord Hutton's principles for reform as enacted in the Public Service Pensions Act 2013.

2.9 Lord Hutton highlighted the collaborative approach being taken by funds within the Local Government Pension Scheme and recommended that the benefits of co-operative working between local government pension funds and opportunities to achieve efficiencies in administration more generally should be investigated further.[4]

> **Recommendation 23**: Central and local government should closely monitor the benefits associated with the current co-operative projects within the Local Government Pension Scheme, with a view to encouraging the extension of this approach, if appropriate, across all local authorities. Government should also examine closely the potential for the unfunded public service schemes to realise greater efficiencies in the administration of pensions by sharing contracts and combining support services, including considering outsourcing.

2.10 More generally, Lord Hutton went on to comment about the need for change and improved scheme data. At paragraph 6.1 he said:[5]

[4] Independent Public Service Pensions Commission: Final Report p.17
https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207720/hutton_final_100311.pdf
[5] Independent Public Service Pensions Commission: Final Report p.122

In its interim report, the Commission noted the debate around public service pensions is hampered by a lack of consensus on key facts and figures and a lack of readily available and relevant data. There are also inconsistent standards of governance across schemes. Consequently it is difficult for scheme members, taxpayers and commentators to be confident that schemes are being effectively and efficiently run. It also makes it more difficult to compare between and within schemes and to identify and apply best practice for managing and improving schemes.

2.11 The Department therefore co-hosted a round-table event to consider these issues with the Local Government Association in May 2013. There were 25 attendees from administering authorities, employers, trade unions, the actuarial profession and academia. The discussion centred on the possible aims of reform, the potential benefits of structural change and the work required to provide robust evidence to analyse the emerging options and establish a starting point and target.

2.12 The objectives for reform identified at the round-table fed into a call for evidence on the future structure of the Scheme, which ran from 21 June to 27 September 2013. This asked respondents to set out the data required to enable a reliable comparison of fund performance and to consider how the administration, management and structure of the Scheme might be reformed to address the objectives identified at the round-table event. These objectives included reduced fund deficits and improved investment returns, as well as reduced investment fees and administration costs, greater flexibility of investment, especially in infrastructure and more use of better in-house investment management.

2.13 133 responses were received to the call for evidence and these submissions have been analysed to inform this consultation. A separate response to the call for evidence has been published and is available at: https://www.gov.uk/government/consultations/call-for-evidence-on-the-future-structure-of-the-local-government-pension-scheme. The Shadow Scheme Advisory Board has also reviewed the responses to the call for evidence and submitted recommendations to the Minister for Local Government. Its findings have been considered in the development of this consultation and are available via a link on its webpage or from the Shadow Board's website: http://www.lgpsboard.org/index.php/structure-reform/board-analysis-menu.

2.14 To support the call for evidence, the Minister for Local Government and the Minister for the Cabinet Office commissioned additional analysis using the Contestable Policy Fund. The Fund gives Ministers direct access to external policy advice through a centrally managed match fund, allowing Ministers to draw directly on the thinking, evidence and insight of external experts. Following a competitive tender process, Hymans Robertson were selected to establish the aggregate performance of the Scheme by asset class and to provide a detailed cost-benefit analysis of three potential options for reform:

- Establishing one common investment vehicle for all funds;
- Creating five to ten common investment vehicles for fund assets
- Merging the existing structure into five to ten funds.

2.15 The analysis set out the costs and benefits of each option; the time required to realise savings; the practical and legal barriers to implementation and how they might

be addressed. Hymans Robertson's findings have been reflected in this consultation, alongside the call for evidence responses and analysis by the Shadow Scheme Advisory Board. A copy of the Hymans Robertson report, which did not extend to making recommendations, is available on the Government's website: https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies

3. The case for change

Summary of the proposals

3.1 Having considered the responses to the call for evidence, as well as the Shadow Board's recommendations and the Hymans Robertson report, the Government believes that the following steps are needed to help ensure that the Scheme remains affordable in the long term for both employers and members. The proposals aim to balance the opportunities from aggregation and scale whilst maintaining local accountability.

3.2 The package of proposals set out in this document include:

- Establishing common investment vehicles to provide funds with a mechanism to access economies of scale, helping them to invest more efficiently in listed and alternative assets and to reduce investment costs.
- Significantly reducing investment fees and other costs of investment by using passive management for listed assets, since the aggregate fund performance has been shown to replicate the market.
- Keeping asset allocation with the local fund authorities, and making available more transparent and comparable data to help identify the true cost of investment and drive further efficiencies in the Scheme.
- A proposal not to pursue fund mergers at this time.

3.3 Hymans Robertson's analysis, which was based on detailed, standardised data, demonstrated that the significant savings could be achieved by the Scheme if all of the funds adopt the following proposals in full. The Government is interested in exploring these proposals further with a view to maximising value for money for taxpayers, Scheme employers and fund authorities.

Proposal	**Estimated Annual saving**
Moving to passive fund management of all listed assets, accessed through a common investment vehicle.	£420 million
Ending the use of "fund of funds" arrangements in favour of a common investment vehicle for alternative assets	£240 million

3.4 The saving of £420 million associated with moving to passive management of listed assets is comprised of two elements:

- Reduction in investment fees: £230 million
- Reduction in transaction costs: £190 million

The performance that is reported by the Local Government Pension Scheme funds is net of these transaction costs.

3.5 The savings associated with passive fund management can be achieved quickly, within one to two years. The annual savings arising from using common investment vehicles for alternative assets would build gradually, with the full annual savings reached over 10 years, as existing contracts came to an end.

3.6 This package of proposals provides a clear opportunity to substantially reduce the investment costs of the Scheme. They are most effective when adopted by all 89 funds and the Government proposes to implement them together. Indeed, the passive management of listed assets could be most easily facilitated through a common investment vehicle.

3.7 In addition, the cost of investment has been estimated to be considerably higher than previously reported. Recognising the need for more reliable and comparable performance and cost data, the Government will continue to work with the Shadow Scheme Advisory Board to improve the transparency of fund data as set out in paragraph 5.3.

3.8 The remainder of this section sets out the objectives and rationale for reform and the evidence underpinning the approach taken. A more detailed explanation of the proposals for reform is provided in section four.

The objective of reform

3.9 The cost of the Local Government Pension Scheme has risen considerably since the 1990s, with the increased costs falling predominantly on Scheme employers and local taxpayers. In England alone, the cost to Scheme employers has almost quadrupled from £1.5 billion in 1997-98 to £5.7 billion in 2012-13. Indeed, when the Welsh funds are also considered, the total cost to employers is around £6.2 billion a year.[6] The Government has already taken action to reduce the cost of the Scheme and make it more sustainable and affordable to employers and taxpayers in the long term. For example, the new 2014 Scheme with a revised benefit structure came into effect on 1 April, helping to reduce and rebalance the cost between members and employers. However, it is clear from examining the aggregate data on the Scheme which has come to light as part of this review, that there is more that can be done to improve the sustainability of the funds.

3.10 At present, the funds report that administration and investment management costs are £536 million per year, of which £409 million is attributed to investment. Indeed, the reported cost of investment in cash terms has continued to rise in recent years: from £340 million in 2010-11; to £381 million in 2011-12; and £409 million in 2012-13.[7] In fact, using more detailed and standardised data CEM Benchmarking Incorporated, as sub-contractors to Hymans Robertson, identified that the fees for investment management of the Scheme could be much higher than reported, at in excess of £790 million. Some of the fees for investment management are not fully transparent to the funds and are therefore difficult to quantify. In practice, the actual cost of investment to the funds is likely to be even higher than £790 million, as their analysis did not include other costs in their calculation such as transaction costs and performance related fees on alternative assets.

3.11 Coupled with the responses to the call for evidence, Hymans Robertson's analysis has provided a system review, shedding light on the aggregate performance of the Scheme by asset class, as well as the transactions and processes that underpin the

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[6] Local government pension scheme funds summary data: 2012 to 2013
[7] Local government pension scheme funds summary data: 2012 to 2013

costs of investment. The work carried out by CEM Benchmarking Incorporated found that while funds were paying investment fees comparable with a peer group of funds of much larger size with similar mandates, there remained considerable scope for savings through a more efficient approach to investment.

3.12 The priorities of reducing fund deficits and improving investment returns set out in the call for evidence are underpinned by one overarching objective: that the Scheme remains sustainable and affordable for employers, taxpayers and members in the long term. Having considered this new aggregate view of the funds, the evidence indicates that there are opportunities to reduce costs without damaging overall Scheme performance. The Government therefore believes that it is right to consider opportunities to reduce costs and deliver value for money for employers and taxpayers, in pursuit of the overarching objective of a more sustainable and affordable Scheme.

Reducing fund costs or tackling deficits?

3.13 Although the call for evidence was developed around the primary objectives of reducing fund deficits and improving investment returns, very few responses set out ideas for managing deficits in a different way. The Shadow Scheme Advisory Board argued that more thinking could be done to consider how deficits might be addressed in the longer term. Its sixth recommendation stated[8]:

> The Board will support the Government by (a) developing a shortlist of feasible options for managing deficits and (b) conducting further research on the costs and benefits of the key options for reform.

3.14 The Government agrees that opportunities to improve funding levels should continue to be explored and looks forward to considering the Shadow Board's proposals for alternative ways of managing deficits. **Respondents to this consultation are also invited to submit any feasible proposals for the reduction of fund deficits.**

3.15 While very few submissions effectively tackled deficit reduction, both public and private sector respondents recognised that the Scheme may benefit from addressing the secondary aim of reducing investment costs, partly by managing investments more efficiently. Taking action to reduce the cost of running the Scheme will help to meet this objective by increasing the funding available for investment. In the longer term, this should help to improve the funding level of the Scheme and reduce the pressure on employer contribution rates. This consultation therefore focuses on the cost savings to be found through collaboration and more efficient investment.

Achieving scale to reduce fund costs

3.16 There is already a growing consensus across the Local Government Pension Scheme that there are opportunities to deliver further efficiencies and savings for local taxpayers through collaboration. When the call for evidence was launched, funds in

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[8] Call for Evidence on the Future Structure of the Local Government Pension Scheme: The Local Government Pension Scheme Shadow Scheme Advisory Board analysis and recommendations, p.4 http://www.lgpsboard.org/images/CFE/20140115SSABreportFINAL

Wales, Scotland and London had already begun to research the benefits of scale and explore the relative merits of mergers and common investment vehicles. Similarly, shared administration arrangements had been established in a number of areas including across Kensington and Chelsea, Hammersmith and Fulham, and Westminster; as well as in Northamptonshire and Cambridgeshire.

3.17 Several responses to the call for evidence cited earlier reports or academic research into the benefits of fund size, drawing heavily on the exploratory work of Scotland, Wales and London, as well as the international experience of countries including Australia and Canada.[9] On balance, these reports found that there was no clear link between investment returns and fund size. However, they did show that there were significant benefits to scale, such as lower investment and administration costs, easier access to alternative asset classes like private equity and hedge funds, and improved governance. This view was also reached by the Shadow Board in its analysis of the call for evidence responses, which argued that:[10]

> The evidence appears to show indirect benefits of larger fund sizes, although any direct link between fund size and investment return in the Local Government Pension Scheme is inconclusive.

3.18 Although managed as 89 funds, with an asset value of £178 billion the Local Government Pension Scheme clearly has the potential to achieve the benefits of scale realised by larger funds. Whilst many of the funds have gone some way to achieving this by using procurement frameworks or establishing joint-working arrangements, there is more that can be done. This consultation will set out how using common investment vehicles and passive management for listed assets can in the long term lead to savings of over £660 million a year for the Scheme.

Achieving efficiencies and safeguarding local accountability

3.19 The call for evidence asked interested parties to suggest options for reform that would best meet the primary and secondary objectives set out in paragraph 2.12 above. A range of tools and approaches to achieving greater economies of scale were suggested, with fund mergers, common investment vehicles, and existing collaborations such as procurement frameworks all discussed extensively.

3.20 Two themes were discussed consistently when respondents sought to evaluate the merits of the main proposals for reform:

- The potential cost and time required for implementation;
- The importance of local accountability.

Costs and benefits of the proposals

3.21 Around half of the responses discussed the cost effectiveness of merging funds and how this might be implemented. Many argued that while savings could be achieved as a result of economies of scale, more analysis was needed to ensure that the benefits

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[9] A list of the most commonly referenced papers can be found on the Shadow Scheme Advisory Board's web-pages: http://www.lgpsboard.org/index.php/structure-reform/responses-public-view

[10] The Local Government Pension Scheme Shadow Scheme Advisory Board analysis and recommendations, p.3

of mergers outweighed the cost and time required to implement them successfully.

3.22 Analysis was undertaken by Hymans Robertson who evaluated the costs and benefits of three options for reform over 10 years. They found that although significant savings could be realised over the period by amalgamating into five funds, merger could take around 18 months longer to implement than common investment vehicles; the delay in the emergence of savings leading to a significant reduction in the net present value of savings over 10 years. The report also showed that the savings achieved by pooling assets into two common investment vehicles would be slightly higher than if 10 were used.[11]

Possible model for reform	Net present value of savings over 10 years (£ billions)
Assets pooled into two common investment vehicles	£2.8
Assets pooled in 10 common investment vehicles	£2.6
Fund assets and liabilities merged into five funds	£1.9

3.23 The calculations shown exclude the impact of the reduced transaction costs, which Hymans Robertson showed would also help to deliver additional savings of £1.9 billion for the Scheme over 10 years.

3.24 A number of fund authorities also submitted evidence of the benefits to their fund of procurement frameworks such as the National LGPS Frameworks. A procurement framework provides authorities with a short list of organisations who can bid for contracts, reducing the time and cost of running a more substantial process.

National LGPS Frameworks' response to the call for evidence cited one fund who had used their actuarial framework to secure services at a procurement cost of £4,000 instead of the estimated £30,000-£40,000 required for a full procurement process. If this same rate of savings applies to Global Custodian procurements, with costs again reduced by 90 per cent, the Framework believes savings of £90,000 per fund can be found.

3.25 Although there are clear benefits to using frameworks, the scale of savings achievable does not match those possible through more substantial reform such as common investment vehicles. However, the Government believes that there is still a role for procurement frameworks to play in delivering savings for the Scheme and is keen to see this opportunity taken up by more of the funds.

Local accountability

3.26 Most call for evidence responses stressed the importance of local accountability and the direct link to elected councillors, which would be lost if funds were merged. At present the authority's Councillors, usually through the pensions committee, are asked to agree the fund's investment strategy. The authority then publishes an annual report which details the costs and investment performance of the fund, enabling the public to assess how effective the investment strategy has been. Some respondents argued that this allows local taxpayers to hold the fund and local councillors to account. As one fund authority stated:

[11] Local Government Pension Scheme structure analysis; Hymans Robertson p.6.

"There is a clear, democratic link to local voters and businesses through elected members sitting on pensions committees…

The regulatory requirements to produce an annual report and accounts and policy statements…ensure that key information on the management of funds is held in the public domain. This approach ensures local and national accountability.

The Pensions Committee believes that a forced merger of funds could only weaken accountability and the democratic link."

3.27 However, a smaller number of respondents queried the benefit of this link, emphasising the importance of Myners Principle 1 – that administering authorities should ensure that investment decisions are taken by persons or organisations with the skills, knowledge, advice and resources necessary to make effective decisions and monitor their implementation.[12] Although Councillors on the committee receive training, there is a risk that they have neither a background in finance nor the time to invest in developing the knowledge required to a sufficient depth. In addition, some suggested that the frequent turnover of Pensions Committee members as a result of the electoral cycle made it difficult to ensure a long term view of the investment strategy.

3.28 The ability to set a tailored investment strategy and determine the asset allocation locally was seen as vital amongst respondents from both the public and private sectors. This is perceived as an important tool for managing each fund's unique funding position and cash-flow requirements. Several respondents also emphasised the importance of local accountability as a means to ensuring the representation of Scheme members and employers. As one Scheme employer set out in their response to the call for evidence:

The existing arrangements in English County Council and London Funds promote and facilitate a clear link between the relevant individual Fund and employing bodies… As the public sector continues to fragment the number of scheduled/ admitted bodies will increase making all the more important a genuinely "local", as presently exists, link between employers and Funds.

3.29 Under a fund merger, asset allocation would need to take place at the new, larger fund authority level. However, common investment vehicles offer greater flexibility and can be established with the asset allocation made either centrally within the vehicle, or by the local fund authority.

3.30 Around 15 responses to the call for evidence stressed that common investment vehicles could achieve the benefits of scale attributed to fund mergers, without the associated disruption, implementation time, cost or loss of local accountability. As one fund outlined when talking of pooling assets in common investment funds:

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[12] Pensions Regulator – adaptation of Myners principles for the Local Government Pension Scheme http://www.thepensionsregulator.gov.uk/docs/igg-myners-principles-update.pdf

This approach might realise significant scale benefits more speedily and with less disruption, while still retaining local accountability and decision making on key matters such as deficit recovery plans and asset allocation.

3.31 Having considered the responses to the call for evidence and Hymans Robertson's analysis, the Government has decided not to consult on fund mergers at this time. However, there remains a strong case for achieving economies of scale through the use of common investment vehicles.

4. Proposals for reform

Proposal 1: Common investment vehicles

The case for change

4.1 Using common or collective investment vehicles to aggregate the Scheme's investments and moving to passive investment of listed assets has the potential to deliver significant savings of over £660 million per year, through reduced investment and other costs for all asset classes in the Scheme. These savings were set out by Hymans Robertson, whose report showed that it was likely that the economies of scale from aggregation would be best accessed through common investment vehicles.

4.2 Further savings arise from the efficient structure offered by a common investment vehicle. Within any common investment vehicle or pooled fund, money will flow in and out as investors purchase and redeem units in the fund. If those buying and selling units within a pool can be matched, fund managers will not need to sell assets to meet redemption requests and as such the volume of transactions can be minimised, improving cost efficiency.

4.3 Common investment vehicles may also deliver savings by reducing the use of "fund of funds" to access alternative assets, such as hedge funds, private equity, property and infrastructure. Fund of funds are used to achieve the scale required for individual funds to make investments they may not be able to access directly. However, this introduces an additional layer of fees, increasing the total cost of investment. Setting up a common investment vehicle would help funds achieve the scale required to invest, without the high costs associated with a "fund of funds".

4.4 Hymans Robertson found that investment fees for alternative assets were particularly high compared to other asset classes, accounting for less than 10 per cent of the Scheme's assets, but for at least 40 per cent of fees.[13] The firm's analysis showed that savings of up to £240 million per year could be achieved by ending the use of "fund of funds" across the Scheme, provided that the existing contracts were permitted to run their full course in order to avoid potentially significant termination costs. Consequently, although some savings would begin to accrue straight away, this annual total would be reached over 10 years.[14]

4.5 The wider benefits of common investment vehicles include improved transparency. As the funds would be subject to the same investment costs and asset managers, the effect of asset allocation and local decision making would become more transparent, revealed in part by the variation in investment returns. This should provide the Department, fund authorities and taxpayers with an opportunity to compare the effectiveness of a fund's asset allocation. In addition, the vehicle could provide a platform for the operation of national framework agreements, helping to minimise the cost of procurement and other administrative costs of investment such as actuarial and custodial services.

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[13] Local Government Pension Scheme structure analysis; Hymans Robertson p.11
[14] Local Government Pension Scheme structure analysis; Hymans Robertson p.7

4.6 A common investment vehicle for alternative assets could also help to improve governance by providing an independent assessment of alternative investment strategies, particularly for local infrastructure investment. A pooled vehicle could make it easier for funds to invest in infrastructure when appropriate opportunities arise, by providing a cost effective way to realise the scale needed.

4.7 As discussed in paragraph 3.28, local determination of a fund's asset allocation was seen as a vital consideration amongst respondents to the call for evidence. A common investment vehicle could be designed to allow asset allocation to remain at local fund authority level, consistent with ensuring that decisions are taken in line with existing local accountabilities.

Proposal for reform

4.8 The Government believes that there are clear advantages to funds in pooling their assets in common investment vehicles for all asset classes, but that all asset allocation decisions should remain with the fund authorities.

4.9 Hymans Robertson's analysis demonstrated that there were slightly higher returns over ten years if the funds were organised through one common investment vehicle for listed assets and a second for alternatives, rather than a greater number. This evidence suggests that savings will be maximised by the creation of two vehicles: a single common investment vehicle for listed assets organised by asset class (for example, UK equity, European equity, UK bonds and so on), and a second vehicle for alternative assets.

4.10 Concentrating the Scheme into two common investment vehicles may increase its exposure to risk. Several public and private sector responses to the call for evidence also stressed that capacity constraints may begin to apply if a fund became too large. As one fund authority stated in their response to the call for evidence:

> Furthermore there may be issues about capacity – the best fund managers may be closed to new business, and even if indeed the capacity exists, they may be reluctant to have too much business from a single client (as that creates business risks).

4.11 However, the Government believes that the exposure to risk should be mitigated if the asset allocation remains as diversified as it is at present. The Hymans Robertson report noted that the issue of capacity constraint would not apply to the common investment vehicle for listed assets if it were invested in passive funds.

Q1. Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Please explain and evidence your view.

Q2. Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?

Q3. How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?

Further considerations

A. Changes to the investment regulations

4.12 The current investment regulations place restrictions on the amount of a fund that can be invested in certain types of vehicle, for example limited partnerships in aggregate are subject to a limit of 30 per cent. In addition, while some types of common investment vehicle are listed within the regulations, others are not. Squire Sanders, as subcontractor to Hymans Robertson, indicated that secondary legislation could be used to reform the investment regulations, removing the anomalies created between different types of vehicle and any ambiguity about the funds' ability to invest substantially in common investment vehicles.

4.13 The Government recognises that the investment regulations are in need of review. The Department will consult separately on reforms to these regulations, including any changes required to facilitate investment in common investment vehicles. **However, any initial thoughts would be welcome in response to this consultation.**

B. The type of common investment vehicle

4.14 The term collective or common investment vehicle can be used very broadly and take different forms. At this time, the Government would like to seek views on the specific type of common investment vehicle to be used, but anticipates that the following principles might underpin the design:

- Pooling of assets, possibly on a unitised or share basis;
- Safeguards for individual funds, for example through Financial Conduct Authority authorisation;
- Governance arrangements considered as part of wider governance reforms arising from 2013 Public Service Pensions Act;
- Strategic asset allocation remains with individual funds; and
- An option for other funded public service pension schemes to participate in the common investment vehicles if they wish.

4.15 There are a number of types of common investment vehicle available that might fulfil some or all of these principles. One such model currently under review is the tax transparent Authorised Contractual Scheme.[15] However, careful consideration of the governance arrangements for any common investment vehicle would be needed before any more detailed proposals are developed.

Q4. What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?

Proposal 2: Passive fund management of listed assets

4.16 There are two main types of investment approach, which can be used individually or in combination.

- Passive management typically invests assets to mirror a market in order to deliver a

[15] More information can be found on the Financial Conduct Authority's website: http://www.fca.org.uk/firms/firm-types/collective-investment-schemes/authorised-contractual-schemes

return comparable with the overall performance of the market being tracked.

- An actively managed fund employs a professional fund manager or investment research team to make discretionary investment decisions on its behalf.

4.17 The Local Government Pension Scheme makes use of both of these approaches, although active management is used more extensively than passive. By applying their expertise, it is hoped that active managers will deliver a level of return in excess of the market's performance, although this comes at a much higher cost than passive management. A few funds gave examples of how they had benefited from active management in their response to the call for evidence.

For example, the active manager of one fund had outperformed their performance benchmark by 3.2 per cent since 2007 and by 5.7 per cent in the last three years.

4.18 However, Hymans Robertson cite evidence from defined benefit pensions funds in the United States which shows that for equities, returns are explained predominantly by market movements and asset allocation policy, with active management playing no role[16].

The case for change

4.19 There are some risks associated with paying for active management, since not all active managers will be able to achieve returns higher than the market rate. Hymans Robertson was therefore asked to examine the performance of the Scheme in aggregate to see whether the funds' overall performance was benefiting from active management.

4.20 Hymans Robertson considered the performance before fees of equities and bonds in aggregate across the Scheme over the 10 years to March 2013. This new analysis, evaluating the funds' investment as one Scheme, showed that there was no clear evidence that the Scheme as a whole had outperformed the market in the long term. They concluded that listed assets such as bonds and equities could have been managed passively without affecting the Scheme's overall performance.

Equity market [17]	**UK**	**North America**	**Europe excluding UK**	**Japan**	**Developed Pacific excluding Japan**	**Emerging Markets**
FTSE Index	10.7	9.5	11.4	7.4	16.4	18.2
Aggregate Local Government Pension Scheme	10.8	8.4	11.6	7.5	17.3	17.1
Excess active return gross of fees	0.1	-1.1	0.2	0.1	0.9	-1.1

[16] Local Government Pension Scheme structure analysis; Hymans Robertson, p.19. Data based on 'Rehabilitating the Role of Active Management for Pension Funds' by Michel Aglietta, Marie Briere, Sandra Rigot and Ombretta Signori.

[17] Local Government Pension Scheme structure analysis, Hymans Robertson, table 9 p.20. Sources: State Street Investment Analytics (The WM Company), CEM Benchmarking Inc. *This is Hymans Robertson's estimate of the extra cost which reflects the low fees that the Local Government Pension Scheme in aggregate pay for active management of UK equities. The global cost premium is estimated by CEM as 0.56%

Extra cost (per annum) of active	0.34*	0.27	0.20	n/a	0.49	0.53

4.21 This analysis of investment return is specific to the performance of the Local Government Pension Scheme in aggregate.

4.22 In their report, Hymans Robertson quantified the fees savings achievable from moving to passive management of listed assets as £230 million per annum, assuming that all funds participated.[18]

4.23 In addition to the savings arising from lower fees, a move to passive management will also reduce the level of asset turnover. This occurs as investment managers buy and sell assets within an asset class. Both passive and active managers buy and sell assets, but turnover is generally much higher, and therefore more costly, under active management. Hymans Robertson estimated that if all of the Scheme's UK and overseas equities had been managed passively in the financial year 2012-13, turnover costs would have been around £190 million lower.[19]

4.24 Hymans Robertson also conducted a detailed analysis of the transition methodology and costs to move to passive management of all listed assets. They identified that the cost of transition could be around £215 million.[20] These transition costs are approximately equal to the savings achieved from reduced turnover costs in just one year.

4.25 Their analysis of transition also concluded that any market disruption will be limited as there is no proposed change to asset allocation. Hymans Robertson suggested that a single coordinated but phased transition would minimise market impact.

Proposals for reform

4.26 The Hymans Robertson report concluded that if the Scheme acts collectively and moves all listed assets into passive management, investment fees and turnover costs could be reduced by up to £420 million per year. This represents a significant saving for the funds, employers and local taxpayers which would begin to accrue within two years of moving to passive management of listed assets.

4.27 Having considered this analysis, the Government believes that funds should make greater use of passive management for all listed assets such as bonds and equities. Alternative assets such as property, infrastructure or private equity would continue to be managed actively through a separate common investment vehicle.

Further consideration

A. Take up of passive management

4.28 A number of the responses to the call for evidence emphasised that a small movement in investment performance has the potential to have a more significant impact on the Scheme's finances than the savings achievable from investment management fees. It is therefore important that full consideration is given to the

[18] Local Government Pension Scheme structure analysis; Hymans Robertson p.7
[19] Local Government Pension Scheme structure analysis; Hymans Robertson p.7
[20] Local Government Pension Scheme structure analysis; Hymans Robertson p.17

impact of a move to passive management on overall Scheme performance.

4.29 The Government acknowledges that, as set out in paragraph 4.17, there are funds who feel they have benefited from active management. However, Hymans Robertson's analysis of the savings associated with moving to passive management of listed assets is underpinned by a full consideration of investment performance by asset class across the Local Government Pension Scheme. This analysis shows that a move to passive management would not have damaged returns across the Scheme as, in aggregate, the funds' investment performance has replicated the market in much the same way as passive investment.

4.30 The Government therefore wishes to explore how to secure value for money for taxpayers, Scheme members and employers through effective use of passive management, while not adversely affecting investment returns. There is a range of options open to Government and the funds to achieve this:

- Funds could be required to move all listed assets into passive management, in order to maximise the savings achieved by the Scheme.
- Alternatively, funds could be required to invest a specified percentage of their listed assets passively; or to progressively increase their passive investments.
- Fund authorities could be required to manage listed assets passively on a "comply or explain" basis.
- Funds could simply be expected to consider the benefits of passively managed listed assets, in the light of the evidence set out in this paper and the Hymans Robertson report

Q5. In light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance, which of the options set out above offers best value for taxpayers, Scheme members and employers?

5. Additional considerations

Data transparency

5.1 Although all of the funds publish annual reports setting out their costs and investment returns, a theme common to the majority of responses to the call for evidence was the need for greater transparency and more comparable data. As one fund outlined in its response to the call for evidence:

> There is currently insufficient information available to permit a robust comparison of different Local Government Pension Scheme funds. This includes data on investment performance, investment management costs, pension administration costs, and actuarial information. All of this data should already be available within each Local Government Pension Scheme fund but there needs to be a central repository to collate and analyse the information and ensure that it is comparable.

5.2 Moving to a common investment vehicle will help to facilitate this transparency, as the investment fees derived from a common vehicle will be more comparable. It will also help to highlight the effect of asset allocation and fund decision making. Since the funds would be investing through the same vehicles, the effect of asset allocation will be more easily seen from the resulting variation in investment returns. The common investment vehicles would also allow greater clarity over variations between asset allocations and actuarial discount rates.

5.3 However, it is clear that further improvements are needed to ensure published Scheme data is comparable between funds. The Minister for Local Government has asked the Shadow Board to look at data transparency in more detail and it has already made progress in this area, bringing together all of the funds' annual reports on its website. The Government is keen to support the Shadow Board in this work and looks forward to working with it to ensure more comparable data is available in the future.

Procurement frameworks

5.4 As set out in paragraph 3.24, there are clear advantages and savings to making use of the National LGPS Frameworks. The frameworks provide funds with the opportunity to reduce the cost and time associated with procurement. By developing a short list of approved candidates, the frameworks can help funds reduce the time taken to procure a service from six to nine months to a matter of weeks, as well as offering standardised terms and conditions. In addition to offering savings to the funds, the small fee paid by funds to access the framework helps to ensure that the model is self-financing in the long term.

5.5 At present, frameworks have been established by the National LGPS Framework for investment consultancy, global custody and benefit and actuarial services. The Government believes that funds can deliver further savings, using these frameworks to procure a range of services including actuarial and investment advice. Funds should give serious consideration to making greater use of these frameworks. In addition, common investment vehicles could be used as a platform from which to operate such frameworks.

Administration

5.6 The question of how to improve the cost effectiveness of administration was posed in the call for evidence as a secondary objective for structural reform. Around 12 submissions suggested that larger funds were able to achieve lower administration costs. Some fund authorities and pensions administrators set out the benefits they had seen from aggregating administration services, arguing that significant savings could be achieve from reduced staff and accommodation costs, greater automation, member and employer self service and I.T cost reductions. For example, as a shared service for fund authorities set out in their response:

> Local Government Shared Services ("LGSS") Pensions Service is a collaborative venture between two Scheme funds established in October 2010, which has already saved £500k per annum in pensions administration.

5.7 However, while these savings are valuable to the Scheme, they are small in comparison to the cost reductions associated with greater passive management of listed assets and the use of common investment vehicles. In addition, as some respondents stressed, the administration of the Scheme is already facing a period of significant change with the introduction of the 2014 Scheme from 1 April 2014.

5.8 Having considered these factors, the Government has decided not to consult on administration reform at this time. However, the call for evidence has highlighted the scope for potential administrative efficiencies as well as the associated risks. At this stage, the Government proposes to allow the administration arrangements for the 2014 Scheme to mature before considering reform any further.

HYMANS ROBERTSON

Department for Communities and Local Government

LGPS structure analysis

December 2013

Linda Selman

John Wright

For and on behalf of Hymans Robertson LLP

PUBLIC SECTOR

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LGPS structure analysis

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Introduction

There is much that the LGPS currently does well and a substantial body of evidence that administering authorities have been good stewards of invested funds:

- The LGPS has procured investment management services at fee levels that compare favourably with those paid by larger international peers, particularly for investments in traditional asset classes – this is testimony to the cost saving ethos and effectiveness of local authority procurement practice; and
- A number of initiatives have already been established and further pilot projects are underway which aim to reduce costs; these include joint procurement frameworks, collective investment vehicles, shared services and voluntary Fund merger.

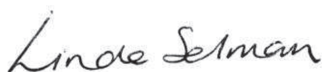
Nonetheless, in order to achieve further meaningful savings, everyone in the LGPS community will need to remain committed to pursuing further and more widespread improvements in investment efficiency through collaboration and reform.

The primary purpose of this research project is to quantify the potential for additional **cost savings** across the LGPS using the best objective evidence and data currently available and to assess how those cost savings might be **accessed most readily**.

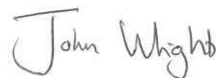
The project deliverables include quantification of potential savings in investment management costs for a range of reform options. However, we were not asked to provide any recommendation on a preferred approach. The preferred approach will be a matter for government to determine after a full consultation.

We are indebted to the commercial organisations and local authorities who made significant contributions to this project by providing performance data, costings and other valuable information that has enabled us to complete this research. We have acknowledged their contributions at the end of this report. The willingness of those organisations to help and the general support we have received from the wider LGPS community during this important project are evidence of the commitment of all involved to make sure that future decisions are based on robust and objective analysis.

This paper is the work of three partner organisations, Hymans Robertson, CEM Benchmarking Inc. (a global firm specialising in the benchmarking of investment performance and costs) and Squire Sanders (UK) LLP (a global law firm with a leading public sector pensions practice). It is the hope of Hymans Robertson and its partners that this report will provide the solid evidence base that is required for a well-informed consultation on the means by which the LGPS can make further cost savings for a sustainable future.



Linda Selman



John Wright

Executive Summary and Key Findings

Purpose of project

- The primary purpose of this research is to quantify the potential for **cost savings** across the LGPS using the best objective evidence and data currently available and to assess how those cost savings might be **accessed most readily**.

Key findings

Investment costs

- Total asset management costs across the LGPS in 2012 were estimated at **£790m** (c.**44bps of total assets**), of which £745m was investment management costs and £45m oversight costs
- On a consistent basis total asset management costs for an international peer group of large funds with same asset mix were estimated at **41bps**.
- The investment costs **exclude**:

  a. performance fees on alternative assets such as private equity, hedge funds, etc. (However, they do include performance fees paid on traditional assets); and

  b. **turnover costs** (investment performance figures include the impact of turnover costs)

- Overall fees paid to fund managers by the LGPS are slightly lower than those paid by large peers for similar mandates. There is evidence that LGPS funds have been successful in securing particularly low levels of fee on some asset classes.
- The greatest potential for cost savings would result from changes to implementation style (i.e. less use of active managers and less expensive means of investing in alternative asset classes).

Investment performance

- There are some funds which have performed consistently well relative to their peers. However, for the LGPS taken in aggregate, equity performance **before fees** for most geographical regions has been no better than the index.
- This outcome is consistent with wider international evidence which suggests that any additional performance generated by active investment managers (relative to passively invested benchmark indices) is, on average, insufficient to overcome the additional costs of active management.

Traditional asset classes – potential savings

- Greater use of **passive investment** ("trackers") for listed equities and bonds could save **£230m (13bps)** per year without damaging investment performance in aggregate across the LGPS.
- Greater use of passive investment is also expected to reduce turnover costs. We estimate that the reduction in turnover cost in 2012-13 as a result of investing passively in listed equities would have been c.£190m.
- The turnover costs are a drag on the performance delivered by active management and their impact is included in the reported asset returns.
- The benefits of passive investment for listed securities are likely to be best accessed through one (or a very small number of) pooled arrangement(s). If this asset pool included both LGPS funds and other non-LGPS pooled investments, this would maximise future "crossing" benefits (matching buyers and sellers to reduce transaction costs). The most appropriate type of collective investment vehicle needs to be established as part of next steps.

- The one-off **transition cost** involved in moving existing LGPS assets into suitable passive investments is estimated to be circa £215m provided the transition is effected over a timescale designed to minimise costs. c.£47m of this is stamp duty.
- To help minimise the transition cost, it would be preferable to have the LGPS implementation carried out as a single co-ordinated exercise; that is what this cost estimate assumes.
- This may seem like a significant up-front cost but it is actually no more than the hidden additional turnover costs incurred in active management which will be saved by investing passively for just one year.
- No additional funding or up-front cash is required from government or from local authorities. Transition costs are met from the assets of the scheme and would be reflected in asset valuations (like other investment transaction and turnover costs).
- Even allowing for other implementation costs, the payback period is likely to be just over **one year** from date of the transition to passive arrangements.

Alternative assets – potential savings

- LGPS funds invest in "**alternative assets**" (private equity, hedge funds, infrastructure) for good reasons (diversification and return). Currently it is difficult for individual funds to access these investments with an appropriate degree of diversification without using "Funds of Funds" approaches. These are expensive because they add additional layers of fees on underlying funds. By pooling assets for alternatives across the LGPS, funds would be able to substantially reduce the use of Funds of Funds.
- Less use of Funds of Funds for alternative assets and early elimination of high fee alternative assets could eventually save another £240m (13bps) **or more** per year. It is not possible to achieve this saving immediately since it will be necessary to:

  a. establish suitable LGPS wide investment vehicles; and

  b. allow existing investments to unwind year by year over the next decade to avoid early exit costs. Further savings might be possible at a later stage using in-house teams. This would require significant investment in specialist in-house resource but we believe this would be more than compensated by more effective implementation and additional fee savings.

How to achieve these cost savings

- All of the above cost savings could be achieved with minimal legislative change (e.g. requiring changes to secondary legislation governing investment limits). If the government chooses to use compulsion to maximise the benefits, there would be additional legal issues to consider.
- While the cost savings identified could be achieved without significant structural reform, asset pooling would be necessary to achieve the full potential of these cost savings and to enable higher levels of participation without which cost savings would be eroded.

Costs and benefits of structural reform

The three options for **structural reform** in the scope of this project were set out by DCLG:

- **Option 1: A single asset pool**

  Under this option the 89 administering authorities would remain but there would be a single collective investment fund for all assets. Decision making on asset allocation and contribution strategies would remain with the 89 administering authorities. They would also continue to be responsible for their own liabilities, employer liaison and member administration.

- **Option 2: 5 to 10 asset pools**

  This option is the same as 1 except that there would be 5 to 10 collective investment funds (groupings beyond the scope of this report). The 89 administering authorities would remain. Each would be responsible for decision making on asset allocation and contribution strategies and for its own liabilities, employer liaison and member administration.

- **Option 3: 5 to 10 merged funds**

  Under this option, the 89 separate LGPS funds would be replaced by 5-10 merged funds. Responsibility for assets, liabilities, deficit management, employer liaison and member administration would all transfer to the new organisations responsible for the 5 to 10 merged funds.

- These three options differ in terms of:

  a. local investment decision making (it is assumed that under options 1 and 2 local decisions on strategic asset allocation would be retained, but not investment manager choice or implementation style);

  b. cost savings (options 2 and 3 may not be optimal scale for cost savings from implementation of passive investment and asset pools for alternatives);

  c. implementation costs and timescale and payback period (option 3 is likely to cost most to implement and take longest); and

  d. legal issues (might be more complex for option 3, fund merger).

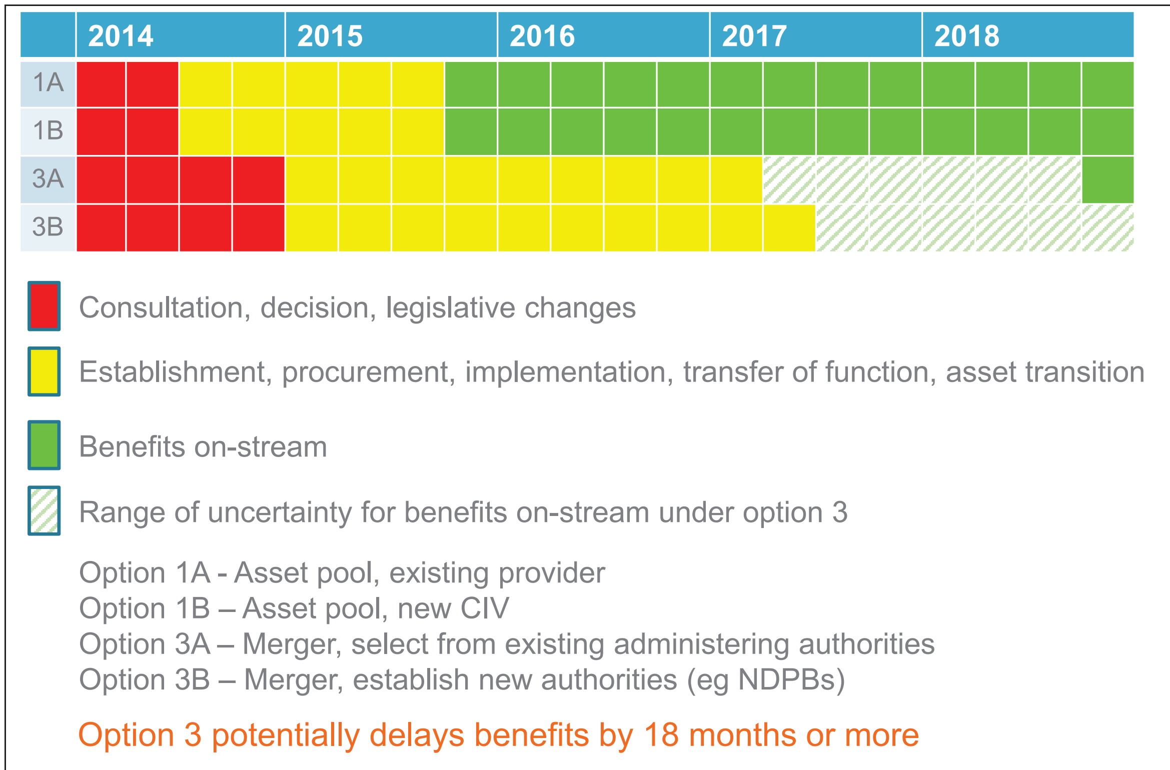
- Under Option 1, the net present value of savings is estimated to be circa £2.8bn over 10 years and £6.6bn over 20 years, based on:

  - Full participation
  - Using very large asset pools for passive investment
  - Using LGPS wide asset pool to reduce the Fund of Funds investment for alternatives

  These numbers take account of investment transition costs which will be paid out of the assets of the scheme. The numbers also take account of other operational costs of new arrangements, including set up costs for any collective investment vehicles and the associated ongoing monitoring and oversight arrangements.

- In addition the net present value of the savings over ten years from reduced transaction costs as a result of switching to passive investment in listed securities is £1.9bn. **Options 2 and 3** have similar benefits, slightly higher costs (although still modest relative to the cost savings) and longer payback periods. In the case of option 3, we have assumed it takes c.18 months longer to implement change. This delay reduces cost savings over 10 years by c.£0.7bn.

The picture below shows the implementation time-line for each of the options.



- The financial benefits quantified in the net present value measure in this report are most sensitive to the following factors, in descending order of significance:

  1 Participation/take-up;

  2 Extent of implementation – passive only or passive and alternatives;

  3 How early the changes are implemented;

  4 The level of fee savings on passive relative to current actual fees across the LGPS; and

  5 Scale of transition cost.

- The LGPS currently spends c£45m on investment oversight (this is twice the amount spent by large international peers). There might be modest additional cost savings in this area (e.g lower spend on advisers). Some of the savings could most appropriately be redeployed on internal resource for more widespread risk management including the greater amount of complexity resulting from the multi-employer nature of the LGPS (a feature not always present in the peer group).

A summary of the net present value of benefits is shown below.

Option	Net present value of benefits over 10 years	Net present value (10yrs) of active management transaction costs	Comments
1	£2.8bn	£1.9bn	• Optimises benefits of pooling assets for passive and alternatives
2	£2.6bn	£1.9bn	• Sub-optimal size for investment scale benefits (e.g. crossing benefits on passive and diversification on alternatives)
3	£1.9bn	£1.4bn	• More complex legal issues to be resolved • Could take significantly longer to implement, resulting in loss of cost savings • Transfer of data and member administration from 89 funds to 5 or 10 makes implementation more onerous and more costly • Combining member administration in this way may not be optimal approach • Sub-optimal size for investment scale benefits • Additional project implementation risk with little additional benefits

Other funded public sector schemes (stage 2)

- In practice it is likely to be extremely difficult to apply any similar approach to cost saving across those schemes, if it involves compulsion on investment choice, since they are governed by private Trust Law and there are greater legal barriers to be overcome. Voluntary participation in any asset pooling may deliver some benefits. The implementation approach for any agreed changes should be designed to make this possible.

Conclusions and summary

The investment fee savings we identify are £470m p.a. In the table below we identify the breakdown of these savings. We estimate that the reduction in turnover cost in 2012-13 as a result of investing passively in listed equities would have been c.£190m.

Cost saving per annum	How	Timescale
£230m (12bps)*	More passive investment	Within two years
£240m (13bps)**	Lower cost alternatives	Full annual saving not achievable until Year 10
£190m (11bps)	Lower turnover	Post transition

* The cost saving equates to 15 bps of the value of listed securities, or 27bps of the actively managed listed securities

** The cost saving equates to 136 bps of the value of alternatives.

- There are a number of **conditions** for the delivery of the estimated benefits:
  - Legislative changes as required (e.g. secondary legislation on current investment limits).
  - Large (industry wide) asset pools to maximise scale benefits including crossing opportunities within passive arrangements.
  - Careful management of the transition to the new passive arrangement to minimise explicit costs and market impact costs (possibly a one-off LGPS wide exercise)
  - For Funds of Funds and alternatives, existing investments should be allowed to run their course to avoid incurring losses due to early redemption. All new investment would be made into new arrangements with lower implementation costs.
  - Full or widespread participation. Our estimates are based on full participation across the LGPS. It is a matter for government whether to use compulsion.
- The potential cost savings outlined above could be achieved with or without significant structural reform. However, asset pooling is necessary to deliver some of the potential cost savings fully (e.g crossing benefits in passive investment and more affordable access to alternatives) and may be helpful to enable high levels of participation without which the benefits could be lost.
- Next steps may include further consideration of legal aspects (especially if the government is considering compulsion) and practical details such as the most suitable and cost efficient types of vehicle for asset pooling (this may differ between passive investment and alternatives) and the mechanism by which the actual cost savings will emerge via employer contribution rates.
- These measures could **reduce LGPS investment costs by nearly a third** if the change to more passive investment is implemented and by **more than half once changes to alternatives work through.** Together the two changes could deliver savings of **£6.6bn over 20 years** if implemented effectively.

Scope, principles, limitations

Options in scope

In this report we consider three options for structural reform of the LGPS set out by DCLG.

Option 1: A single asset pool

Under this option the 89 administering authorities would remain but there would be a single collective investment fund for all assets. Decision making on asset allocation and contribution strategies would remain with the 89 administering authorities. They would also continue to be responsible for their own liabilities, employer liaison and member administration.

Option 2: 5 to 10 asset pools

This option is the same as 1 except that there would be 5 to 10 collective investment funds. The 89 administering authorities would remain. Each would be responsible for decision making on asset allocation and contribution strategies and for its own liabilities, employer liaison and member administration.

Option 3: 5 to 10 merged funds

Under this option, the 89 separate LGPS funds would be replaced by 5-10 merged funds. Responsibility for assets, liabilities, deficit management, employer liaison and member administration would all transfer to the new organisations responsible for the 5 to 10 merged funds.

Objective

The primary objective of this exercise is to identify (and quantify using the best currently available data and evidence) the most significant potential cost savings and to assess how they might most readily be achieved under the three options. A different objective would require a different approach to the assessment and analysis of the options for structural reform.

Clearly all cost savings are measured relative to the status quo.

Scope of report

The scope includes:

- quantification of current investment management costs (including investment management costs and turnover costs)
- identification (and quantification) of potential cost savings and the means by which they might most readily be achieved
- analysis of net of fees performance;
- estimation of cost of change (investment transition costs, cost of establishing new structures, future operational and oversight costs)
- cost benefit analysis of the three options; shape and timing of emergence of savings; payback period; annual cash savings and, since could be different under current actuarial practice, timing of high level implementation programme;
- emergence of benefits via contribution reductions; risks to benefits realisation; sensitivities on financials;
- practical and legal impediments to implementation (and benefits realisation); and
- high level assessment of the applicability of the options in scope to other (non-LGPS) funded public service schemes.

In benefits quantification, the focus is on "hard" data on cost reduction, rather than potential less easily quantifiable performance enhancements, including "governance premium".

The following are NOT in scope:

- a recommendation on which option should be taken forward;
- dealing with deficits;
- member administration; and
- quantification of any governance dividend under different structure.

We have not considered how liabilities are managed; however, we have made the assumption that each employer will remain liable for the financing of their own liabilities, so the number of “employer liability pots” will be the same irrespective of the option chosen.

Principles

In undertaking this project we have sought to adhere to the following principles:

- benefits quantification is evidence based, using the best data currently available;
- where there is no reliable, relevant evidence or data for benefits, this is not taken into account in the central scenario in the cost benefit analysis;
- our reporting is restricted to commentary and analysis based on data and evidence, not opinion (if there are any grey areas at the boundaries we distinguish between fact and opinion);
- we state any critical conditions for the delivery of any assumed benefits (e.g. the degree of participation);
- our analysis of legal barriers is based on our understanding of the law as it currently stands.

Reliances and Limitations

Our report is addressed to our client for this project, the Department for Communities and Local Government (DCLG), for the sole purpose of assessing the cost and benefits of three options for structural reform of the LGPS (and other funded public sector pension schemes) as set out in the scope above along with practical and legal impediments to change. It has not been prepared for any other purpose.

This report must not be shared with any other party without our prior consent and if shared must be disclosed in its entirety. We do not accept any liability to any third party.

The information in this report is based upon our understanding of legislation and events as at 12 December 2013 and we have used all reasonable endeavours to ensure the accuracy or completeness of the information contained herein. DCLG acknowledge that we have relied on data and legal advice provided by our partner organisations in compiling this report, CEM and Squire Sanders, both under sub-contracting arrangements. Whilst reasonable efforts have been made to ensure the accuracy of the data and advice expressed, we cannot verify the accuracy of such advice and data and we cannot be held liable for any loss arising from use and/or reliance on such advice and data.

It should be noted that we do not provide legal services and therefore, we accept no liability to any third parties in respect of any legal opinions expressed in this report. Third parties are advised to take independent legal advice in respect of any legal matters arising out of this report.

A number of other organisations provided data to assist the project; for the avoidance of doubt, those organisations not party the client agreement with DCLG are not in any way liable for data they have provided.

1 Cost assessment

Highlights

- Based on data from a sample of 18 LGPS funds who volunteered their data, total asset management costs across the LGPS in 2012 were estimated by CEM Benchmarking Inc at £790m (c.44 bps of total assets)
- Of this £745m was investment costs and of that c.£710m was paid to active managers
- Moving equities and bonds fully passive would reduce fees by c.£230m p.a.
- The cost of transitioning equities and bonds to passive is estimated to be c £215m, of which £47million is stamp duty on purchases of UK equities
- The reduction in turnover cost in 2012-13 as a result of investing passively in listed equities would have been c. £190m.
- Alternatives are less than 10% of total assets but account for 40% of total fees
- Management costs for alternatives could be significantly reduced by reducing/removing the use of fund of funds though this would take time to achieve due to the long term nature of the underlying contracts.

Total costs of managing the assets

In order to assess the total costs of the management of the assets of the LGPS and then identify where and to what degree savings can be made we have relied on analysis carried out by CEM Benchmarking Inc based on detailed information supplied voluntarily by 18 LGPS funds with total assets (as at 31 December 2012) of £38bn. This sample is representative of the LGPS by fund size; i.e. it represents small, medium and large funds in appropriate weightings. Table 1 below shows the breakdown by asset size.

The CEM analysis has identified the total costs and allocated them across asset classes down to a very detailed level and by implementation method (active vs passive, internal vs external, direct vs fund of funds). These realistic costs have then been applied to a fund size of £180bn with the actual asset allocation of the aggregate LGPS. Appendix 1A sets out the methodology applied by by CEM and provides more detailed results from their analysis.

Table 1: Analysis of funds included in CEM investment cost benchmarking exercise

Fund size	All LGPS	Funds included
£5bn +	29.9%	23.6%
£2-5bn	35.1%	46.2%
£1-2bn	20.9%	19.4%
Less than £1bn	14.0%	10.7%
Total	100%	100%
Total Assets	£180bn	£38bn
Number of funds	89	18

Investment management costs

The CEM analysis at aggregate Scheme level extrapolates from the data provided by eighteen LGPS funds to estimate total investment management fee costs of £750m, equivalent to 41.5 bps of the assumed assets of £180bn. These costs include performance related fees on conventional assets but exclude performance-related fees on alternative assets. Turnover costs are also excluded.

Table 2 below breaks down these costs by asset class and by active and passive management.

Table 2 – investment management costs by asset class

Asset class	% of total assets	Active fees (£000)	Passive fees (£000)	Total (£000)	% of total fees
Equities	65.8	256,963	31,103	288,068	38.5
Bonds and cash	17.6	54,535	7,141	61,674	8.2
Property	6.8	97,996	0	97,996	13.1
Alternatives	9.8	300,883	268	301,151	40.2
Total	**100.0**	**710,377**	38,512	**748,890**	**100.0**

While this is a huge amount of money, the CEM analysis indicates that the LGPS as a whole is paying on average less than the peer group for active external investment management which makes up the bulk of the costs. The peer group would be paying £18m more than the LGPS for similar services. This reflects our experience that many funds have negotiated well with managers to bring their fees down. In particular, the data provided to CEM shows that LGPS funds are paying significantly less in fees paid for active management of their UK equities compared to that paid by the peer group; this may be at least partly influenced by the fact that the UK is the home market for LGPS funds. This differential is sufficient to reduce the total annual investment management fees paid by the LGPS by c. £50m. While there may still be scope to negotiate lower fees, the inevitable conclusion is that there is a limit to the benefit that can be secured by seeking further reductions in manager fees. It follows that, if costs are to be reduced significantly, other solutions have to be found.

The larger part of the fee burden suffered by the LGPS is for active management (£710m) which is significantly more expensive than a passive approach. Chart 1 (opposite) compares the allocation of LGPS fund assets with the fees paid to manage those assets. The chart highlights how cheap passive management of equities is and the disproportionate amount of the LGPS fee budget that arises from investment in alternatives. The management of active equities and bonds together account for £311m of fees. Alternatives account for less than 10% of the assets but for at least 40% of the fees (CEM's analysis does not capture performance-related fees on alternative assets).

Chart 1: Total LGPS fund value and fee budget split by asset class

Reducing investment management costs

There are three key ways to reduce the costs of the investment management of the assets of the Scheme;

1 Reduce the level of active management in favour of passive – the fees for passive management are significantly lower than the fees for active management;

2 Reduce the layers of fees that are inherent in fund of funds arrangements which are common in the management of property and alternatives, and

3 Move more of the assets from external to internal management.

Reducing active management in favour of passive

In aggregate, the LGPS uses less passive management than the peer group of large funds in the CEM analysis. (The use of passive management by the 18 LGPS funds combined is higher than that of the peer group of funds in the £25-£45 billion size group. However, the very large global funds make more extensive use of passive management than both LGPS funds in aggregate and global funds in the size range up to £45bn).

Realistically passive management is only available on listed assets, i.e. bonds and equities where there are market indices which can be replicated using either physical stock or derivatives or ETF's. Based on the analysis of the data submitted to CEM, we estimate that there is potential to save up to £230m p.a. if all of the equities and bonds are managed passively. Over 80% of these gains (c£193m) is attributable to equities. While there would be costs involved in transitioning from the current actively managed portfolios to passive which we quantify below, the savings are relatively easily accessible.

Table 3: Estimated fees p.a.after moving all of equity and bond management to passive

	Fees (£000)	% of total fees
Equities (all passive)	95,217	18.4
Bonds (all passive)	23,089	4.5
Property (all active)	97,996	18.9
Alternatives (predominantly active)	301,151	58.2
Total	517,453	100.0

We consider in Chapter 2 of this report the potential impact on performance, i.e. the returns that may be generated from an asset structure which is predominantly passive compared to one that is managed actively. We have included a more detailed analysis of the fee savings achievable for listed securities by moving from active management to passive in Appendix 1B.

Reducing the layers of fees in fund of funds arrangements

The Scheme has more assets in fund of funds than the peer group. This is likely to be due to the relatively small size of the individual LGPS funds relative to the average size of the peer group. The fund of funds route has enabled the LGPS to diversify their exposure but comes with an additional layer of fees. We believe that there are significant savings to be achieved by accessing alternative assets more directly than the Scheme does at the moment. There is global research which identifies the reduced costs achieved by very large funds that invest directly into private equity in general and infrastructure in particular. CEM's analysis indicates that the higher use by the Scheme of fund of funds arrangements for investing in private equity relative to the global

peer group adds c. £14m to investment management costs; the peer group still has a significant level of fund of funds exposure so there could be even bigger gains to be made than this figure indicates.

However we believe that the costs involved in 'dismantling' the existing fund of fund structures are likely to be extremely onerous and that the sensible approach would be to allow existing closed end funds to run off, while ensuring that any commitment is conducted differently / directly. Lower costs will be easier to achieve if we can identify some means of consolidating the assets of the Scheme that are allocated to alternatives, e.g. into a single entity, to access investment opportunities as cheaply and effectively as possible. We return to this below.

Moving assets from external to internal management

External active management tends to be much more expensive than internal or passive management. The Scheme uses more external management than the peer group. CEM's analysis indicates that the impact on the costs of the Scheme of using more external management than the global peer group is of the order of £57m of which c.£21m are associated with alternative assets. Research carried out by CEM[1] showed that the fee for an active EAFE (essentially global ex North America) equity mandate managed externally was over four times as much as an internally managed mandate (46bps v 10 bps).

Six of the 89 LGPS funds in England and Wales already manage a significant portion of their assets internally and qualify for inclusion in State Street's peer group of internally managed UK pension funds. (To qualify for inclusion more than two thirds of assets must be invested by in-house fund management team.) We consider the relative performance of internally and externally managed funds in Chapter 2.

Oversight, custodial and other costs

The CEM analysis indicates that if the experience of the 18 funds is extended to the whole Scheme, the LGPS is estimated to be spending c.£45m on oversight, custodial and other asset related costs. This includes consulting and performance measurement of c. £11.5m. CEM estimates that as a whole the LGPS is paying c £22m more than the peer group with c £9m of this being excess consulting and performance measurement costs. The balance of the excess cost is allocated to 'oversight'. Given that for the LGPS this represents the costs of 89 funds, each with similar oversight functions, against the cost of a single fund in the peer group there is an implication that reducing the number of entities required to oversee the investments could result in some savings and that this should be possible without compromising the quality of the oversight. (Alternatively the same expenditure might be applied in more effective ways through collaboration or structural change.) However the cost savings here are of second order magnitude compared to the potential savings in direct investment management costs.

[1] **'The World's Lowest Cost Funds, Herbert Lum, Research Director, CEM Benchmarking Inc, Oct 2006**

Table 4: comparison of Oversight, Custodial and Other Costs

Activity	LGPS (£000s)	Peer Group(£000s)	Cost/savings(£000s)
Oversight	19,077	6,512	12,565
Custodial/trustee	9,881	9,881	-
Consulting /performance measurement	11,522	2,696	8,826
Audit	1,911	1,274	637
Other	2,542	2,839	-297
Total	**44,933**	**23,202**	**21,731**

Other costs of investment – turnover and transactions costs

All investment portfolios suffer transaction costs due to dealing in the underlying assets. Even a passively managed portfolio has some turnover due to changes in the constituents of the benchmark which will happen at regular intervals and the need to re-invest dividend income from the underlying holdings. The level of activity in an actively managed portfolio can be significantly higher and this has an adverse impact on costs. Not all transaction costs can be measured easily and accurately. There are explicit costs like broker commission and stamp duty which are measurable but other 'implicit' costs like the bid offer spread, market impact and opportunity cost are harder if not impossible to measure. Appendix 1C sets out more detail and definition of the components of transaction costs.

Table 5 below sets out the annual cost impact at the level of turnover of the market index for equities and the additional cost for incrementally higher levels of turnover.

Table 5: Turnover and transaction costs (bps)

		excess cost relative to passive			
Market	passive	25% turnover	50% turnover	75% turnover	100% turnover
UK	0.08	0.20	0.45	0.70	0.95
North America	0.01	0.06	0.14	0.21	0.29
Japan	0.01	0.14	0.29	0.44	0.59
Europe ex-UK	0.03	0.09	0.21	0.32	0.43
AP ex Japan	0.04	0.15	0.33	0.51	0.69
Emerging Markets	0.10	0.20	0.48	0.76	1.04

According to State Street, the average internally managed fund turns over a quarter of its UK equity portfolio each year while the All Funds Universe average is 46% p.a. If we apply the turnover that State Street identified for the LGPS in the 2012-13 year across both UK and overseas equities and compare this to the cost of turnover if all of the equities had been managed passively, the extra cost identified is of the order of £190m p.a. This assumes that the turnover in non-UK equities is evenly spread across all regions and comes with the

caveat that the costs of turnover vary by region. Due to stamp duty of 0.5% on purchases the UK is an expensive market in which to trade, beaten only by emerging markets. It should be noted that this analysis does not capture all the elements of implicit costs e.g. market impact. We estimate that market impact could add a minimum of a further 5 bp of total equity assets turned over to costs, i.e. an additional £56m p.a.. Table 6 below sets out the composition of the £190m.

While there might be some debate about the actual transaction costs incurred by managers, it is worth noting that the transaction levels in 2012-13 were lower than the average for the five years to 2013. Based on the average turnover for the five years to 2013, the £190m would become £240m assuming the same transaction costs.

Another element of transaction costs is generated by mandate turnover as funds replace managers who have underperformed. However the impact of these transactions is included in the turnover identified by The WM Company and cannot easily be separated. The procurement activity associated with mandate turnover generates additional costs but these are small in relation to the other costs of change.

Table 6 – estimated cost of turnover for LGPS equities

Market	One-way turnover %	Estimated. transaction costs (bid/offer plus fees) %	Excess cost of active manager turnover	Asset allocation at 1 Apr 2012 %	Extra cost on £180bn (£000s)
UK	22.5	1.00	0.175	25.4	79,827
North America	34.5	0.30	0.092	10.8	17,881
Japan	34.5	0.60	0.199	3.4	12,202
Europe ex-UK	34.5	0.45	0.137	8.0	19,732
Asia Pacific ex Japan	34.5	0.72	0.215	3.6	13,908
Emerging Markets	34.5	1.12	0.308	5.2	28,871
Global	34.5		0.150	6.0	16,200
Total				**62.4**	**188,621**

Costs of turnover in government bonds will be significantly lower than in equities though the level of turnover is likely to be higher; State Street identify 45% one-way turnover in government bonds for the aggregate LGPS in 2012-13. Transaction costs in alternative assets are significant.

Investment management costs under status quo and alternative structures

Increasing the element of passive management

It would be possible to increase the proportion of the Scheme managed passively under either 'status quo' or any of the three alternative structures that this report considers.

The research we have done, as part of this project, on the passive management of equities leads us to the conclusion that there is a significant advantage to being an investor in a very large fund. The advantage comes from the reduction in frictional costs of trading either into or out of the passive pool of assets and from the regular rebalancing activity that is required. The managers of passive funds that we interviewed all described a process whereby flows of money either into or out of the passive fund benefit from a high degree of 'crossing'. Simply put, with a large number of investors with different behaviour patterns, at any dealing date there are likely to be both buyers and sellers. The first stage of deciding how to manage these transactions is to match

the buyers and sellers as far as is possible at the unit level (e.g. one investor selling UK equity fund units and another investor buying). The next stage is typically to use the residual cashflow to carry out any desirable rebalancing to improve the tracking of the assets in the fund. After that there may still be further opportunities for matching at the asset level with transactions that are taking place for other clients. However the larger part of the crossing is done at the unit level, perhaps because the 'shape' of the trades, buys and sells, is a good match. The managers we interviewed cited crossing between 20% and 60% of cash flows at unit level and relatively modest levels, c 10%, of crossing at asset level.

Under the status quo the bulk of LGPS assets that are managed passively are invested in pooled funds managed by the three largest passive managers and therefore arguably already benefit from the unit crossing of a large fund. As an example of scale, Legal and General's UK equity fund is £42bn and the resources applied to the management of the firm's passive business include c. 20 investment managers.

Option 1 implications

If the passive investment of the 89 funds was in a pooled fund or funds (if more than one manager were employed) dedicated to LGPS then there is likely to be a reduction in the crossing opportunities as all of the investors are likely to have cashflows going in the same direction as each other. While the UK equity assets would amount to almost £46bn, there would only be about £6bn invested in each of Japan and Pacific Basin ex Japan if the current asset allocation were maintained across the Scheme.

Option 2 and 3 implications

The same issues, i.e. reducing the opportunities for crossing units, apply as for option 1 although, with even fewer LGPS participating in each collective investment vehicle (CIV), the chance of crossing opportunities would be even lower. Under the 5 fund scenario would be c £36bn, resulting in less than £9bn of assets in the UK equity sub fund and around £1.25bn each in Japan and Asia Pacific Basin ex Japan.

Under each of these two options the issue of scale might be addressed by either;

- The CIV(s) holding units in one or more of the existing pooled funds rather than investing on a segregated basis, or
- Agreeing an arrangement with an existing passive manager to set up a sub-fund within an existing fund specifically for LGPS investments.

There are a number of reasons why we do not believe that internal management can compete with the current external managers of passive funds;

- The low fees that currently prevail for passive management
- The value of the crossing opportunities that are available when there are different investors in the pool with varying cashflow patterns
- The significant costs of resourcing the activity effectively (e.g. L&G have a team of c 20 managers allocated to managing passive mandates)
- The track record the existing managers have of adding value relative to benchmark.

Reducing the layers of fees in fund of funds arrangements

The evidence globally is that it is only the very largest funds that invest directly into alternative assets using their own internal resources. This reflects the significant costs associated with the level of due diligence required to invest directly into private equity or infrastructure. Under options 2 and 3, even with only five CIVs, we do not believe that it would be practical to achieve adequate diversification for each £36bn fund through direct investment. We believe direct investment in alternative assets is only viable if the assets allocated are invested in a single and appropriately resourced collective vehicle.

Moving more of the assets from external management to internal management

A study by CEM[2] showed that on average six front office investment staff were required for every US$10billion (£6bn) of assets managed internally. State Street[3] report that the internally managed LGPS funds employ teams that range in size from 8 to 22 with an average of 13. The largest of the internally managed LGPS funds is c. £10bn so LGPS staff numbers look quite large. State Street suggest that this may be because the LGPS funds are small relative to the funds in the CEM study (average US$90billion). However, our discussions with a number of the internally managed funds suggest that these figures probably include the 'back office' and accounting staff. CEM found that for every one front office investment member of staff there were 1.7 staff members engaged in governance, operations and support. Under the 5 fund model in options 2 and 3, this would imply 36 front office staff and 60 back office staff for each of the 5 asset pools or merged funds if all of the assets were managed internally. However these staffing requirements would be reduced if the listed assets were managed passively.

Transition costs – increasing the element of passive management

While it is clear that, once in place, passive management of the equities and bonds would be cheaper than active management there are costs involved in the transition. In order to quantify these costs we designed a hypothetical transition. This involved moving all of the listed equities and bonds that are currently managed actively (apart from the small elements that are currently managed internally) to passive management.

The total costs of transition are estimated as c.£215 million. It should be noted that c.£47 million (22%) of the estimated transition cost is UK Stamp Duty on the purchase of UK equities involved in the reorganisation.

The cost estimate for transition assumes that implementation is carried out as a single co-ordinated exercise. The process and timescale for the transition is designed to minimise costs. The volume of trades involved will require multiple tranches of transitions to avoid high market impact costs.

Appendix 1D provides more information on transition methodology and the estimated costs.

[2] 'How Large Pension Funds Organize Themselves', Jody MacIntosh and Tom Scheibelhut, Spring 2012
[3] Lessons from Internally Managed Funds, March 2013

2 Performance impact of changes in asset management

Highlights

- While some funds have a good and consistent performance, there is no evidence that, in aggregate, the Scheme has outperformed regional equity markets over the ten years to 2012-13
- This is consistent with both UK and global evidence which suggests that any additional performance generated by active investment managers is on average insufficient to overcome the additional costs of active management
- There is evidence that internally managed pension funds in the UK have outperformed those with no internal management even before fees are taken into account
- However, global evidence suggests that the lower cost of internal management is the main reason for the outperformance of funds that have more internal management.

Methodology

In this chapter we examine the potential for the changes in the management of the assets to impact on the investment performance. We have examined published research that provides evidence on UK and Global pension funds. For LGPS specific data we have used two sources of data;

1. Our proprietary database of LGPS fund performance which records for each fund, performance at total asset level for each the eight financial years from 2005-06 to 2012-13. This database has been built up over time by sourcing data from the published Annual Reports. It forms the basis for Table10 below.
2. Data supplied by State Street Investment Analytics detailing the returns by asset class at the aggregate Scheme level for each of the 10 years from 2003-05 to 2012-13. This information is summarised in Appendix 2a and forms the basis for Table 9 below.

The LGPS investment model

The most common model for the management of the assets of an LGPS fund is a combination of active and passive management with external managers being hired to manage all of the assets. Those funds that have made allocations to alternatives, specifically hedge funds, private equity and infrastructure, have used a significant level of fund of funds structures. Some of the property exposure also incorporates funds of funds to get adequate diversification. A number of funds have some element of internal management (most commonly passive equities) but only six qualify for inclusion as internally managed under State Street's definition which requires over two thirds of the assets to be managed in-house.

There is a significant cost differential between active and passive management as we have shown in Chapter 1. Active management is selected on the assumption that the manager will outperform the benchmark by more than the additional cost of investment. The focus on what the extra cost is has been on the element that relates to manager fees. However, as we demonstrated in Chapter 1, there is an additional drag on active performance from the higher levels of turnover that active managers undertake. The impact of transaction costs is included but hidden in the reported performance. Although managers are required to make disclosures on the costs they incur, it is impossible to identify the full impact of trading costs.

Comparison of performance of active v passive management

UK evidence

State Street Investment Analytics published their most recent analysis of Active and Passive Management in July 2012. In the report, they 'consider the ranges of risks and returns for passively and actively managed equity portfolios of UK pension funds relative to broad market indices.'

Table 7 below shows the ten year returns by equity market for the passive and active equity portfolios of UK pension funds. The passive portfolios have, as expected, closely tracked the appropriate indices; the weighted averages for all regions are within 0.2% of the index return. The record of the actively managed portfolios shows a range from an outperformance in World Pacific ex Japan of 0.9% p.a. to an underperformance of 1.1% p.a. in North America.

The returns quoted do not take account of investment management fees.

Table 7: Ten years to end 2011: Index and Weighted Average Returns (% p.a.) (Gross of fees)

Equity market	UK	North America	Europe ex UK	Japan	Developed Pacific ex Japan	World Pacific ex Japan
FTSE Index	4.8	2.8	4.3	2.5	12.1	10.9
Passive Portfolios	4.8	2.6	4.3	2.6	12.2	-
Active Portfolios	4.9	1.7	4.5	2.0	11.8	11.8

Global evidence

Research based on the asset allocations of US defined-benefit pension funds for the period 1990-2008 tested the role of three factors, market movements, asset allocation policy and active portfolio management, in explaining their returns. The results are reported in 'Rehabilitating the Role of Active Management for Pension Funds' by Michel Aglietta, Marie Briere, Sandra Rigot and Ombretta Signori. Table 6 below summarises their findings.

Table 8: decomposition (%) of pension funds' actual net returns 1990-2008 (Net of fees)

Factor	Global Allocation	Stocks	Fixed Income	Cash	Real Assets	Hedge Funds	Private Equity	TAA
Market*	90	96	70	26	47	54	26	75
Asset allocation	4	2	3	13	2	2	2	5
Active Management	2	0	20	36	40	40	54	16
Interaction effect	4	2	7	25	11	4	18	4

*Market returns are defined as average returns of all pension funds

While the performance of traditional asset classes is driven mainly by market movements and active management makes little impact, active management plays a significant role for the alternative asset classes, particularly real assets, hedge funds and private equity. For equities, 96% of the return volatility is explained by market movements, 0% by active management and 2% by policy allocation. For real assets, market movements account for only 47% of performance while active management accounts for 40% highlighting the potential to add value through asset selection due to the heterogeneity of performance.

LGPS evidence at aggregate Scheme level

Data from State Street Investment Analytics (The WM Company)

A number of LGPS funds have a good and consistent record of investment performance over long periods. However this is not replicated across the Scheme. In this section we consider the performance that has been achieved within equities (broken down into regions) and bonds. We do not consider the contribution from asset allocation.

We have examined the data for the aggregate LGPS (including Scotland and Northern Ireland) for the ten year period ending on 31 March 2013.

Table 9: Ten years to 31 March 2013; Index and weighted average returns (% p.a.) (Gross of fees)

Equity market	UK	North America	Europe ex UK	Japan	Developed Pacific ex Japan	Emerging Markets
FTSE Index	10.7	9.5	11.4	7.4	16.4	18.2
Aggregate LGPS	10.8	8.4	11.6	7.5	17.3	17.1
Excess active return	0.1	-1.1	0.2	0.1	0.9	-1.1
Extra cost (p.a.) of active	0.34*	0.27	0.20	n/a	0.49	0.53

Sources: State Street Investment Analytics (The WM Company), CEM Benchmarking Inc.

*this is our estimate of the extra cost which reflects the low fees that the LGPS in aggregate pay for active management of UK equities. The global cost premium is estimated by CEM as 0.56%

Appendix 2A includes detailed analysis of performance across equities and bonds broken down into different time periods. Although some periods show stronger performance than others, there is no strong evidence that the aggregate Scheme has outperformed the market in the long term.

The funds' aggregate equity returns and the funds' regional equity returns are highly correlated with the broad market index. Correlation data provides an indication of the strength of the relationship between the funds' returns and the underlying index returns. It does not provide any information on the scale of the relative moves. For example, even the returns of a very active equity manager are likely to be highly correlated with the broad market index, typically in excess of 0.8. The correlations observed at aggregate Scheme level in equities are well in excess of 0.9 which reflects the high degree of overlap between the fund and the index holdings. Considering performance at the aggregate Scheme level masks the extent of the dispersion of returns across the funds.

Analysis based of Hymans Robertson's data

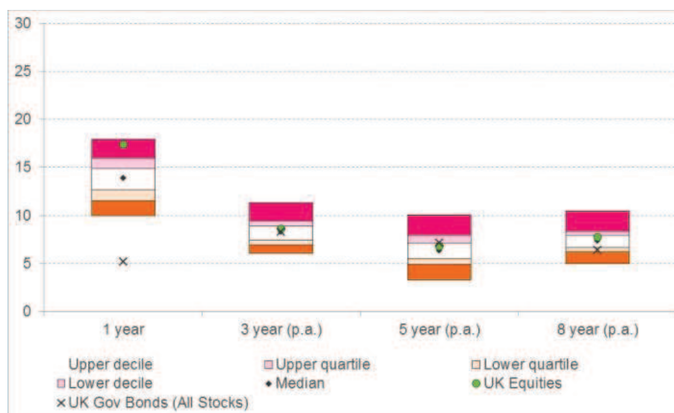
We have gathered the performance data for each of the LGPS funds at aggregate fund level over the eight years to 31 March 2013 and analysed it for each annual period and over the longer term. The difference here is that we are able to track the performance of each individual fund. Table 10 overleaf shows in tabular and graphical form the dispersion of returns over 1, 3, 5 and 8 years and for reference plots the returns for UK equities and UK government bonds over the same periods. Over 8 years the best performing fund has returned 5.5% p.a. more than the worst performing fund. Our analysis shows some evidence of funds with both consistently good and consistently poor performance.

In Appendix 2B we have included some further analysis by fund size. That analysis shows that there is no strong evidence that larger (>£1bn) LGPS funds have performed better than smaller funds (<£1bn) though there

is evidence that the performance is more widely dispersed for the smaller funds. This is counter to global research on the performance of large funds relative to small funds and may reflect the small sample size and the fact that even the largest LGPS fund is small in the global context.

Table 10: Dispersion of returns for LGPS funds over 1, 3, 5 and 8 years to 2012-13

	1 yr	3yrs (p.a.)	5yrs (p.a.)	8yrs (p.a.)
Maximum	17.9	11.3	10.1	10.5
Upper quartile	14.9	8.9	7.1	7.9
Median	**13.9**	**8.3**	**6.4**	**7.4**
Lower quartile	12.6	7.4	5.5	6.7
Minimum	10.0	6.0	3.3	5.0
UK equities	**17.4**	**8.6**	**6.8**	**7.8**
UK gov. bonds	**5.2**	**8.3**	**7.2**	**6.4**



Comparison of internal versus external management

UK evidence

State Street Investment Analytics monitor the performance of 21 funds that manage more than two-thirds of their assets internally using an in-house fund management team. The analysis was last performed on data as at end December 2011 when the funds were valued at £174bn. The average size of the internally managed funds was £8bn; four funds were valued at less than £1bn. Six of the funds that were included were LGPS funds and their total assets amounted to £17bn.

Table 11: Performance of internally managed funds (%p.a.) to the end of 2011 (before fees)

	5 yrs	10yrs	20yrs	25yrs
Internal	3.7	6.2	8.6	8.9
All Funds	3.5	5.9	8.3	8.6
Relative	0.2	0.3	0.3	0.3

As the cost savings from using internal management are significant, the differential performance after costs are taken into account will be even more substantial.

Global evidence

Research by CEM[4] showed that funds with more internal management outperform funds with less at the total fund level. On average, funds earned 4.6 basis points more net value added for every incremental ten percent of internal management. The lower cost of internal management was the main reason for the differential.

Further research by CEM[5] examined the differential in performance between internal and external management at the asset class level. They found that before costs there was no statistically significant difference in gross value added performance between internal and external management at the asset class level. However, after costs were deducted internal management performed better than or equal to external management in all asset classes considered and there was a statistically significant difference in the performance of internally managed global non-US developed market equities (EAFE) of 96 basis points of net value added. Table 12 below summarises the results.

Table 12: Higher (lower) value added for internally managed assets in bps

Asset class	Gross of costs	Net of costs
US Stock	(23)	0
EAFE Stock	57	96
Emerging Markets stock	(32)	28
Fixed Income	(15)	0

The findings were consistent across country of domicile for the funds and across fund sizes in excess of $20billion and those less than $20billion.

Internal management in the LGPS

We have identified five LGPS funds each of which would qualify to be included in the State Street Investment Analytics peer group of funds that are managed internally. Table 13 overleaf summarises their performance relative to the universe of LGPS funds over the eight years to 2012-13 and relative to their own benchmarks over ten years. While these funds have done well relative to their peer group they have not all managed to beat their benchmarks which provide a measure of what would have been achieved through passive management.

[4] **Internal Management Performed Better, Hubert Lum, December 2007**

[5] **Internal management does better after costs, Terrie Miller and Chris Flynn, October 2010**

Table 13: LGPS Funds with internal management

Fund	Total assets as at 31 March 2013 £bn[1]	Performance % p.a. 8 years to 31 Mar 13[2]	Rank over 8 years[2]	10 year Fund performance % p.a.[1]	10 year Benchmark return % p.a.[1]
Derbyshire	3.1	8.1	19	9.9	9.6
East Riding	3.1	7.9	29	10.1	10.2
South Yorkshire	5.3	8.3	12	9.9	9.9
Teeside	2.9	8.5	7	10.2	9.4
West Yorkshire	9.9	8.3	10	10.2	n/a

Sources: [1]Fund Annual Reports 2012-13, [2]Hymans Robertson database

As part of our research for this project we interviewed three out of these five funds to find out more about how their internal arrangements work and their investment philosophy. A key characteristic which is borne out by global evidence was low turnover at both stock and mandate level and indeed one cited the low turnover as having added 20-25bps to performance.

Impact of reducing the use of fund of funds

Implementation using fund of funds results in high costs and this has an inevitable impact on performance. Research by CEM highlights that the fund of funds style of investing under-performed direct internal investing by 6.8% for private equity (1996-2012), by 5.5% for property (1995-2012).

Table 14: Average value added (%) relative to customised investible benchmarks* by implementation style

Asset Class	Internal	Direct Limited Partnership	Fund of Funds
Private Equity	6.2	1.8	-0.6
Real Estate	0.7	-1.1	-4.8

* The investable benchmarks use a mix of public market equity and REIT indices that varies by region. The benchmarks are custom-lagged for each fund. The real estate benchmark is adjusted for the higher leverage of public indices.

The fees disclosed for these alternative asset classes are frequently understated. The three most common reasons are:

- Management fees are frequently reduced by revenue sharing (commonly called rebates)
- Carry (e.g. performance fees) is excluded
- For fund of funds, the costs of the underlying funds are excluded.

3 Financial analysis

Highlights

- Moving all of the equities and bonds to passive management will produce fee savings of c £230m p.a.
- Reducing the use of fund of funds and removing very high cost alternatives will produce further fee savings of c £240m p.a. though the full annual saving will not be achievable until year 10
- The cost of transitioning the equities and bonds to passive management is estimated at £215m
- These are the elements that have the biggest impact on the calculation of the net present value of the savings. The additional costs, e.g. establishing, operating and overseeing collective investment vehicles, are relatively insignificant, although we have taken them into account,
- The financial benefits are most sensitive to the following factors in descending order of importance
  - The participation or take-up rate (i.e. how many of the LGPS funds decide to invest through the pooled approaches)
  - The extent of the implementation of the changes – passive only or passive and alternatives
  - How early the changes can be made
  - The level of the savings on passive relative to current actual fees paid across the LGPS
  - The scale of the transition cost
- The net present value calculated over ten years varies by option; Option 1 £2.8bn, Option 2 £2.6bn and Option 3 £1.9bn

Overview

The financial analysis is based on two components, relating to the change of investment approach:

- The costs involved in undertaking the change; and
- The benefits arising over time from the changes which result in lower manager fees. In relation to benefits, the basis we have employed is to evaluate benefits in a relative sense, i.e. the difference between the new fees and the fees currently being paid by the LGPS in aggregate

The financial plan takes account of the incidence of both costs and benefits. Our analysis in Chapter 2 showed that there will be no meaningful impact on the returns generated under the new investment approach. Accordingly, we have made no allowance for either higher or lower investment returns.

Administration services are out of scope for this project. We have therefore excluded any assessment of potential future cost savings from re-organisation of administration services, under all three options.

Costs

The principal costs are:

- Establishment costs, e.g. the costs of specialist operating resource (personnel, support and infrastructure, including IT) for any new entities that are created. We have assumed a fixed cost of £500,000. It may be possible to use private sector partners in this area to contain costs.
- The cost of a dedicated investment management team for the collectivised alternative assets. We have made assumptions as to the initial size and quality of the investment team and allowed for this team to

grow in the years following establishment. An allowance has been made for the costs of office space, IT and other support services. This element of our assumptions was 'sense checked' against the actual experience of IFM Investors who have extensive experience of investing in alternative assets. IFM was established over 20 years ago and is owned by 30 major not for profit pension funds.

- Costs relating to the creation of collective vehicles. This will depend on the number of vehicles and their structure, e.g. different approaches might be required for listed securities and alternative assets. We have assumed a cost of £300,000 for a listed securities vehicle and £780,000 for an alternative assets vehicle.
- Contractual adjustment costs relating to procurement of new agents that are necessary and any penalty costs relating to the terminations of contracts of existing agents. Because notice periods are short (typically 3 months or less), we do not believe there to be any material termination costs.
- Project management, actuarial advice (for option 3) and legal costs.
- Transition costs relating to the direct and implicit costs involved in restructuring assets. This is the dominant cost element and essentially relates purely to the listed asset component. Much of the investment in alternative assets is held in closed-ended funds which would be expensive to exit early. Consequently, we have assumed that existing investments in closed-ended funds will be maintained and allowed to run off. However, we envisage that new investment in alternatives would adopt a different structural approach.

Benefits

The principal benefits arise from:

- A switch from active to passive management for listed assets, which results in a significant saving in fees. We have used the data set out in Chapter 1 of this report.
- A gradual shift in the management of an element of alternative assets, from a fund of funds approach to a direct or funded approach. The benefit comes from the removal of an additional layer of fees, although the fact that the closed ended funds are allowed to run off means that the benefit comes through gradually. We have assumed the run-off takes place evenly over a 10 year period.
- The early closure of high fee contracts, where termination is straightforward (without penalty) and where the value of the product is of questionable value (in an aggregate LGPS context). This benefit amounts to c. £100 million p.a.; we have assumed that it will start to emerge 12 months after the decision to proceed is taken.

Time period

Our approach enables us to model the incidence of costs and benefits quarter by quarter. We modelled the first 10 years and the next 10 years. We have used a discounted cash flow basis to calculate the net present value (NPV) of the aggregate saving (benefits less cost) over the first 10 years of the project.

A key assumption for the purpose of quantifying benefits is the implementation timeline, including assumptions as to when costs will be incurred and when benefits will start to emerge. More detail on implementation plans and timelines is given in Chapter 4. For consistency, net present value calculations for all options have been calculated as at 1 January 2015. We have assumed this is the date when the decision is taken regarding the option which is to be adopted.

For the purpose of financial modelling, central assumptions in the net present value calculation include the following:

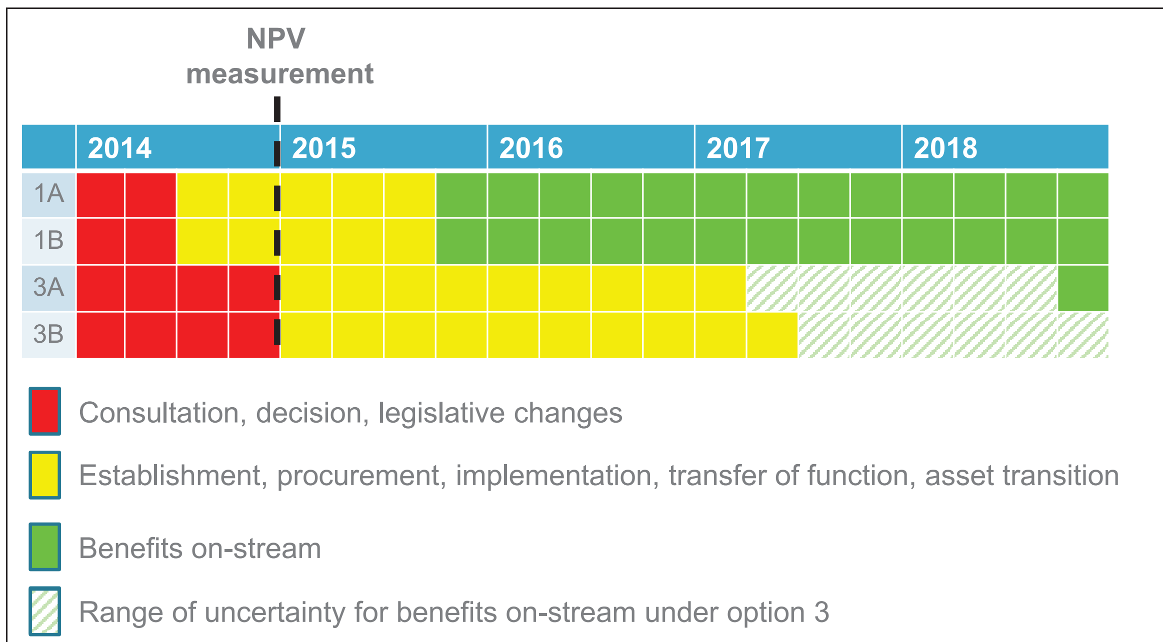
1) Under options 1 and 2, cost savings from the switch to passive investment come on-stream in Q4 2015;

2) Under option 3 (fund mergers), there is an 18 month time lag relative to options 1 and 2. Cost savings are assumed to start emerging in Q2 2017.

We expect the transition to new operational arrangements to take longer for option 3 (fund merger) because of the additional work and complexity involved in transferring membership data and records, member administration and liabilities, particularly if new administering authorities are established. There is also greater uncertainty in our timeline estimates for full fund merger due to greater uncertainty over legal impediments.

In practice the time lag could be greater than the assumed 18 months, in which case our estimate of the NPV of benefits under option 3 (over a 10 year period measured from 1 January 2015) could be an overstatement. On the other hand, even under option 3, the switch to investing passively (using asset pooling across the LGPS) could be implemented before fund merger, so the cost savings could emerge sooner.

The following graphic shows the incidence of various aspects of the project for structural change.



Other financial assumptions

- Initial value of the assets - £180bn
- Asset growth rate – 6% p.a.
- Discount rate – 5.5% p.a.
- CPI assumption – 2.5% p.a.

Risk to savings delivery

The principal risks to delivery of the savings will arise from:

- A take up of the new structure which is lower than modelled or in which the take-up comes through more slowly
- Time delay, i.e. if implementation is held up
- Greater transition costs than modelled.

Sensitivity to assumptions

Participation/take-up

Assuming there is no compulsion, the assumption relating to the extent of participation in the new investment structure has a significant impact on the savings that can be anticipated. We have tested the impact of 100%, 50% and 10% participation. With lower participation, the cost of transition will reduce and this has been reflected in our modelling. However the costs of creating collective vehicles and the establishment costs are unlikely to reduce.

While, as we have observed earlier in this report, the impact of turnover and transaction costs in active portfolios is already reflected in the reported performance numbers, we have indicated the incremental impact on savings of this element of cost for each level of participation.

Costs

The largest element is the transition cost, which for a full transition to passive management has been estimated to amount to £215 million. This assumes that, after consolidating listed LGPS assets and identifying the portion to be traded, the transition is managed over a period of time rather than being achieved in a 'big bang' approach. Approximately £47 million reflects UK stamp duty on the buy side of the UK equity transition. We have tested the impact of the transition cost being 10% and 100% higher than estimated. This latter figure represents something close to a 'big bang' approach.

We have indicated the sensitivity of the savings to the option adopted, allowing for the additional costs involved for options 2 and 3 of having five collective investment vehicles rather than one. Additonally we have modelled a delay of 18 months in implementation for option 3 due to the additional legislation that is likely to be required.

Benefits

The major element relates to the fee reduction arising from the change from active to passive management on quoted equities and bonds which amounts to approximately £230 million p.a. in current cost terms. A change in the approach to the management of alternatives results in the gradual emergence of savings of approximately to £1.1 billion over 10 years assuming 100% participation.

We have modelled our central assumption of £230 million p.a. savings and savings £30m higher and lower. We have estimated figures for all 3 of the options.

Observations

- The level of take-up will have a significant impact on the savings achieved
- The extent of the implementation, i.e. whether the alternatives are restructured as well as moving the traditional assets to passive, is likely to have the next most significant impact
- In contrast a variance in the cost of the transition to, or the fees paid for, passive management will have a more limited impact.

Summary results - Comparative savings over 10 years

Table 15: sensitivity to take-up/participation – option 1 assumed

Take-up	Savings in manager fees		Manager fees and transaction costs
	Passive and alternatives £bn	Passive Only £bn	Passive only £bn
100%	2.8	1.7	3.6
50%	1.4	0.8	1.8
10%	0.2	0.2	0.3

Table 16: sensitivity to DCLG options (1, 2 and 3) and transition costs – assumes 100% take-up

Transition cost assumption	Option 1 (one passive CIV, 1 alternatives CIV) £bn	Option 2 (5 passive and 5 alternatives CIVs) £bn	Option 3 (5 passive and 5 alternatives CIVs with 18 month delay in implementation) £bn
£215m	2.8	2.6	2.0
£240m	2.8	2.6	2.0
£400m	2.6	2.4	1.8

Table 17: sensitivity to DCLG option and level of passive fees – assumes 100% take-up

Assumption for savings from passive fees	Option 1 (one passive CIV, 1 alternatives CIV) £bn	Option 2 (5 passive and 5 alternatives CIVs) £bn	Option 3 (5 passive and 5 alternatives CIVs 18 month delay to implement) £bn
Central assumption - £230m across equities and bonds	2.8	2.6	2.0
Lower savings on passive - £200m	2.5	2.2	1.7
Extra savings on passive - £260m	3.2	2.9	2.3

4 Implementation project plans

Introduction

In this chapter we set out high-level implementation plans for establishing and managing a collective investment vehicle (options 1 and 2) and for fund merger (option 3). More detailed plans can be made available.

Assumptions specific to establishing CIVs (options 1 and 2)

- We have made some specific assumptions.
- DCLG is shown in the project plan in relation to the current project. We have assumed the involvement will relate to a preferred collective investment option. The period may be extended to allow for consultation. It is not clear to what extent activity will be conducted by other groups while the consultation proceeds.
- We have assumed there will be a "managing entity" which will direct activity around a collective vehicle. Because this will involve management activity over and above investment management, we have assumed that the managing entity will not be the direct "operator" of the collective investment vehicle, but will have a subsidiary company which will be the operator; this assumes that the managing entity will have "control" of the operator, rather than using a third party operator. The operator will need to be regulated by the FCA, which is the reason for setting it up as a subsidiary of the managing entity. Other activities conducted by the managing entity include:
  - Producing promotional and other material for potential CIV investors, i.e. LGPS funds
  - Reporting to and communicating with investors, both in relation to investment management activity, but also discussing aspects such as range of investment options, fee discussions, performance reporting
  - Monitoring the activity of the operator
  - Monitoring the activity of CIV providers (managers, custodian, etc.)
  - Assisting with resource, e.g. human resource function, IT, administrative personnel, offices accommodation, compliance, etc.
  - Assisting with procurement.
- We have assumed that a steering group will be established as a predecessor to the managing entity. This could be formed of a committee set up by a group of established administering authorities. The steering group would conduct preliminary investigations around the architecture of the collective vehicle. The managing entity is essentially a legal formation set up to continue the activity initiated by the steering group. The precise legal form of the managing entity is not defined – it might be formalised within an existing entity which collaborates across administering authorities.
- In order to establish the collective vehicle, both the operator and the vehicle itself will need (FCA) authorisation. The managing entity is likely to be a 'qualifying parent undertaking' under Part 12A of FSMA. The FCA has powers to oversee and give directions to the parent of an authorised person if that parent is not itself authorised.
- We have assumed that there will be a pilot transition of assets into the CIV, e.g. a single asset class transition could take place, as a live test of processes, prior to building out a wider group of sub-funds. This might not be consistent with a major transition to passive investment, which is likely to be more effective (in terms of speed and transition cost) if conducted in a single step.
- The actual project plan will depend on the specific architecture within the collective vehicle, so elements of the plan will change to accommodate specifics.

- We outlined implementation plans for two scenarios:
  - Under 1A we assume that an **existing provider** is procured – there may be savings in the establishment costs and timescale but any time saving may be offset by the required length of the procurement process;
  - Under 1B we assume that a **new vehicle and operator** are established as described above.

Fund merger (option 3)

- We considered two scenarios:
  - Under 3A, we assume that **existing administering authorities** are selected to run the 5 merged funds. This may reduce the time taken to establish and make operational the new arrangements. However, time must be allowed for a transparent and rigorous selection process.
  - Under 3B we assume that **new agencies** are established to run the merged funds. These may be some form of Non-Departmental Public Body (NDPB). It may take any new agencies longer to become operational since they will need to procure property, staff, systems and external services and establish and test their own operational procedures and controls before the process of transfer from existing administering authorities can commence.

For fund merger (3A and 3B) in addition to transferring assets, the implementation will include transfer of all functions associated with the running of an LGPS fund including member administration, employer liaison, in-house investment monitoring and management and governance arrangement. This is a complex exercise and is likely to take significantly longer to implement. We assume that this activity is over and above the structural changes that might be implemented on the investment management side since the 5 merged funds will need access to asset pools to achieve cost savings on investment management (the primary focus of this research).

Key stages

The table below sets out the main stages involved in each of the options. The detailed plans behind these stages can be made available.

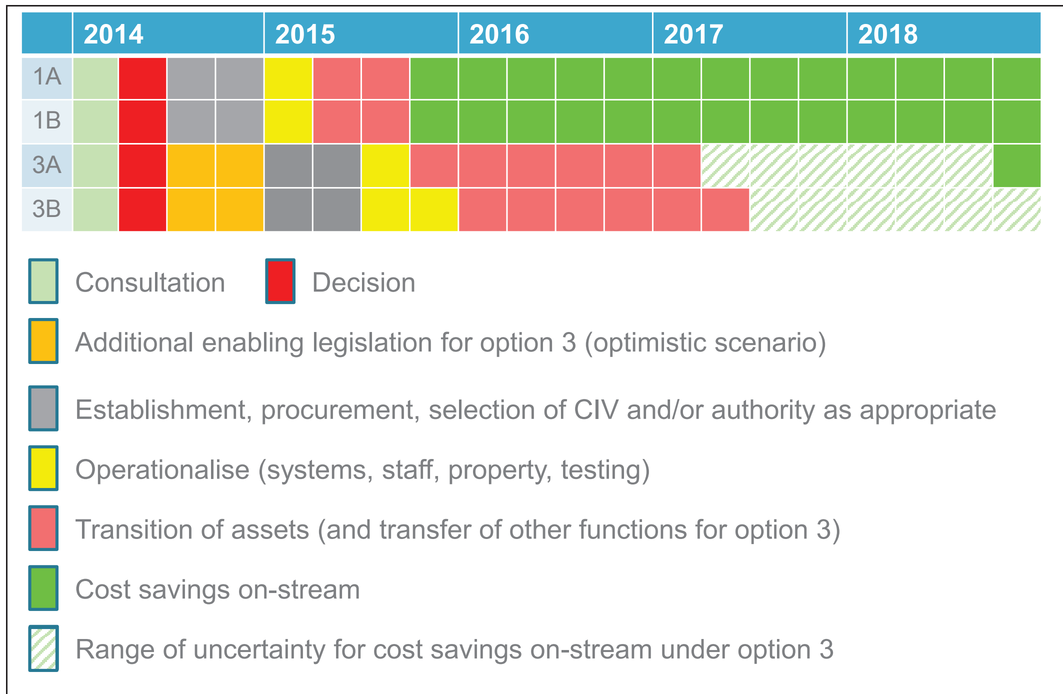
Table 18: Key stages and elapsed time from January 2014

Option	1A Asset pooling Existing provider	1B Asset pooling New vehicle and operator	3A Merger 5 existing authorities	3B Merger 5 new authorities
1) Consultation	3m	3m	3m	3m
2) Assessment of consultation responses; government decision	3m	3m	3m	3m
3) Legislation changes	N/A (c.6m but in parallel with 1) and 2)	N/A (c.6m but in parallel with 1) and 2)	6-18m	6-18m
4) Specify requirements for new entities	N/A in parallel with legislation	N/A in parallel with legislation	N/A in parallel with legislation	N/A in parallel with legislation
5) Establish new vehicle / authorities or select from existing	6m (procurement)	3m (select)	6m (selection process)	6-12m
6) Operationalise (infrastructure, controls, procure IT for administration, staffing)	3m	6m	3m	6-12m
7) Transition (assets) and transfer (liabilities and member admin)	6m	6m	18-24m	18-24m
8) Benefits start to emerge	21 months (Q4 2015)	21 months (Q4 2015)	Between 39 and 57 months	Between 42 and 72 months

High level comparison of timelines

The illustration below compares timelines for options 1A, 1B, 3A and 3B.

- Option 1A - Asset pool, existing provider
- Option 1B – Asset pool, new CIV
- Option 3A – Merger, select from existing administering authorities
- Option 3B – Merger, establish new authorities (eg NDPBs)



Conclusions

Clearly asset pooling (options 1A and 1B) can be effected considerably more quickly. There is a greater degree of uncertainty over implementation timescales for fund merger (option 3) – possibly in the range 3 to 6 years from January 2014 - depending on the implementation approach and the time taken to resolve legal aspects.

For financial modelling of cost savings we have assumed there is a timelag relative to options 1 and 2 of at least 18 months before cost savings from option 3 (merger) come on-stream.

5 Practical impediments to change and mitigation

Background

The main impediments to change relate to:

1. The level of adoption for any new structure or change in investment approach designed to reduce costs, i.e. obtaining "buy in" or creating statutory powers to compel;
2. Difficulties around new implementations arising from Schedule1 limits within the current LGPS Investment Regulations;
3. Delays arising from any need for new entities to be established;
4. Delays or difficulties arising from funding and resourcing any new entities with required skills;
5. Project risk in relation to the restructure; and
6. Whether costs of the restructure will exceed benefits that can be achieved over a reasonable time frame or any lack of certainty over the potential scale of benefits.

Some of these impediments apply to each of the three options under consideration, for example, the current Schedule 1 limits (2 above). The impact of items 3 and 4 above may differ between one option and another.

Practical impediments to change

Issue	Resolution
Making the change There are risks and costs relating to the change in structure.	
• The opportunity for other means of cost saving is foregone while new entities and vehicles are being established	• Formal planning will minimise delays. Some other opportunities may continue
• The project may take longer than expected or may be implemented poorly	• Formal planning will minimise delays and risks of poor implementation
• Provider contract termination penalties may add to costs	• Notice periods are short, but a full assessment would be required
• Procuring providers will add delay and cost	• This will depend on the structure used and the parties procured
• Who will bear the costs of change?	• The charge will be against assets (see estimate)
• Transition will have an impact on markets	• Unlikely if well planned and phased
• Transition costs may be significant (or higher than envisaged)	• Should have large retained assets and low disruption. • Significant existing security turnover will be suspended. The saving in normal turnover cost will offset transition cost. • Existing investments in alternatives will be allowed to run off avoiding early termination costs.

Risks to realising benefits

Issue	Resolution
Criticisms of proposed changes – stakeholder concerns	
• Savings could be achieved without setting up CIVs. A feeling that any of options 1/2/3 are taking a sledgehammer to crack a nut.	
• A belief held by well-run funds and funds with good performance that the real problem to be addressed is poorly performing funds and good funds should be left alone	• If there is no compulsion, funds with good performance can opt out
• A perception or belief that option 3 will result in merging deficits and cross-subsidies between well-funded and poorly funded funds and employers.	• Easily avoided. Actuaries can continue to track individual employer/fund costs
• It is too difficult	• Switch to passive for listed assets is relatively straightforward
• Savings will be too small	• Report shows expected savings
• Significant shift to passive has impact on active managers	
• Significant shift to passive – scepticism about passive and belief that active management benefits are worth the extra cost	• Research indicates lack of certainty of returns from active management
• Change in asset allocation will disturb markets (and investee companies)	• No asset allocation shift planned
• Decision making will become more concentrated, thereby increasing risk	• Asset allocation decision making left with funds in options 1 and 2
• Investment entities will become too large, creating capacity limits which will inhibit investment choice	• Move to passive essentially removes capacity constraints on listed assets. Scale will improve efficiency on alternative assets
• New entities may be inadequately resourced?	• Require adequate resourcing as a condition
• Will the new structure be future proof?	• Address in the plan

Details to be addressed

Issue
Who will bear the cost of change?
Entities running collective vehicles and merged funds
• Who will run the collective vehicles and merged funds?
• What procurement process is required for their selection as operators?
• How and by whom will collective vehicles and merged funds be governed and held accountable?
• What level of resource do new entities require?
• Existing administering authorities have tax-raising powers which, in extremis, might be used to finance pension obligations not met by participating employers. Under option 3, would the entities running merged funds have precepting powers or ability to levy?
Collective vehicle investment choices
• What investment choices would be available?
• Can new categories of asset be added?
• Will “hedging” categories (e.g. liability hedging) be included?
• What alternative asset options would be made available?
Actuarial aspects
• Impact of cost savings on employer contributions

Future proofing

To what extent are the options future proof? The current project relates only to investment elements of structural reform. Can the result allow for:

- Future flexibility in funding and contribution management?
- Future flexibility in member and employer administration?

Option 3 has greater challenge in this area than options 1 and 2. The entity running a “merged fund” would need skills in investment, funding strategy (deficit management) and administration. These are essentially independent skill sets. The optimal future structure for administration, for example, may not be the same as that for investment pooling. Setting up an entity to manage all of three of these activities

- would be more complex;
- could add to establishment costs;
- could delay implementation and the emergence of cost savings.

6 Legal impediments to change and mitigation Squire Sanders

Issue	Resolution
Powers to enact change Options 1 and 2 Can funds be compelled to invest assets exclusively in collective investment vehicles which have been set up?	No power currently exists. Secondary legislation would be required to change the current investment powers of an administering authority
Option 3 Status of "power" to merge funds (assets and liabilities)	Would need specialist counsel opinion to determine if primary legislation can be avoided and to rebut challenge.
Investment regulations Limits within existing legislation will inhibit the flexibility of pooled vehicles to provide the appropriate solutions	Re-draft the Investment Regulations (e.g. using a prudential risk framework)

Executive Summary: Legal Issues

Options 1 and 2: Common Investment Vehicles: Issues and Interim Conclusions

1. The power of investment of an LGPS fund is vested in the administering authority, which also has a duty to invest monies it does not need to make payments from the fund. As such, since there is no power for another person, such as the Secretary of State, to exercise that function instead without regulatory intervention, administering authorities cannot be compelled to exercise their discretion to invest in a CIV (or any other instrument) without removing that function from them. On how such intervention might be made, however, see below generally under Option 3.

2. The Investment Regulations currently constrain LGPS funds' investment powers by reference to some, but not all of the available structures and do so by reference to the legal form of the vehicle. Those Regulations expressly restrict investments in unit trusts, open-ended investment companies (OEIC) and life insurance unit linked funds when such vehicles are managed by the same body to impose maximum limits of 35% of fund assets at the time when an investment is made. Limited partnerships in aggregate (whether or not managed by the same body) are subject to an overall maximum limit of 30%, again measured at the time the investment is made.

3. Further limits apply by reference to other investments according to whether the investment is listed on a recognised stock exchange. Unlisted investments which are not caught by another limit under the Regulations are in aggregate limited to 15% of the fund, again at the time the investments are made.

4. The Regulations' treatment of the financial services authorisation status of the expressly defined collective vehicles mentioned in 2 above is not the same. In order for an OEIC to benefit from the 35% limit, it must be a UCITS fund. This has implications for the investment powers of an OEIC, when compared to the alternative named vehicles, when used by an LGPS fund, as it would be constrained by the UCITS prudential rules in a way which need not apply to an unauthorised unit trust or limited partnership. A unit linked life fund is subject to separate prudential rules on the "permitted links" that the fund may hold, so again there are constraints as to what that vehicle may invest in.

5. While the unit trusts and limited partnership models have therefore an advantage in terms of investment freedom, they would, as with any other non-UCITS and non-life insurance funds, be subject to the Alternative Investment Fund Managers Directive, which imposes prudential rules on both the managers of such vehicles (and third parties involved in their operation) and the vehicle itself. Each model will have significant financial services implications in its establishment and operation.

6. The Regulations are silent on other legal forms of collective investment which are recognised under foreign jurisdictions. These include established overseas vehicles, which operate on a tax transparent basis, such as the Irish common contractual fund and the Luxembourg equivalent, fonds commun de placement. (Other Luxembourg law collective vehicles could be used.) The Regulations may limit investments in these other vehicles if they are incapable of being otherwise characterised as unit trusts, OEICs or limited partnerships, either to the unlisted securities limit of 15% and/or to a single holding limit of 10%.

7. The new UK equivalent to these Irish and Luxembourg tax transparent entities, the authorised contractual scheme (ACS) may be established on either a limited partnership or a tenants in common co-ownership basis. The ACS is not mentioned in the Investment Regulations, so the same consideration of how the limits apply to an ACS on the tenants in common model as in 6 above would apply; the alternative limited partnership structure is of course covered by the Investment Regulations.

8. Different regulatory capital and tax treatments apply to each of the above vehicles, so the cost of operation and the investment efficiency of each from an LGPS fund's perspective will differ according to which model is used. Similarly, there are recognised means of segregating liability under sub-funds for some but not all models.

Collective Investment Vehicles: Key Differentiators

	Unauthorised UT	OEIC (UCITS)	LP	ACS	Life Fund
Direct Ownership of Assets by investors	no	no	yes	yes	no
Capital Requirements for operator	AIFM	UCITS	AIFM	AIFM	Life Directives (solvency II soon)
Restrictions on Investments	QIS limits (mainly real estate)	UCITS limits	QIS limits (mainly real estate)	QIS limits (mainly real estate)	Permitted links restrictions
Tax Transparent	no	no, but favourable tax regime	yes	yes	no but favourable tax regime
Enhanced Insolvency Protection	no	no	no	no	policyholders ahead of unsecured creditors
Segregation of Sub-Funds	no	yes	no	yes	no

Conclusions

The anomalies created between the different collective investment vehicles could be addressed under secondary legislation by removing the current limits and adopting a prudential framework as used in the private sector. This would need to be accompanied by governance changes to ensure that the new flexibility created by reform of the Investment Regulations was not abused.

Option 3: Merged funds

Issues

9. A full merger of LGPS funds into however many new funds are deemed appropriate can only be achieved by confirming that the assets and liabilities of existing administering authorities can be transferred from their current control to other authorities or to new statutory bodies. In turn this leads to the following question: does the Secretary of State have the necessary powers to compel mergers of assets and liabilities? If not, primary legislation will be necessary to create such powers.

10. It is also necessary to look at other powers than those which govern the transfer of assets and liabilities. These include the degree of statutory prescription of functions which applies to current administering authorities and how scheme employers are mandated to adhere to a particular LGPS Funds.

11. The final consequential issue is whether third parties, whose rights and obligations are not expressly covered under the statutory framework, can also have their obligations and rights novated or assigned to apply to a new structure without individual contractual amendments.

Interim conclusions

12. The Secretary of State does possess broad powers to make regulations under both the Superannuation Act 1972 (1972 Act) and the Public Service Pensions Act 2013 (2013 Act) in relation to the LGPS. The architecture of the legislation is complex. The LGPS is one scheme (in the sense of a tax approved entity as opposed to different benefit structures created over time) and, although governed by different legislation, administering authorities' funds are not hypothecated by reference to pre and post 2014 benefit structures. Where statutory powers differ under primary legislation, care must be taken about interpreting how they may be exercised to the scheme as a whole and to administering authorities' funds individually.

13. Our analysis of these powers confirms that while they are very similar in wording and effect in nearly all cases, particularly in relation to the way that administering authorities are mandated to have responsibility for their own funds and how scheme employers are attached to such funds, the wording used in relation to the power to "amalgamate" (ie merge) funds is different. Under the 1972 Act, there is an express power to amalgamate, but under the 2013 no such express power exists. It should be noted that the relevant powers relate to "funds", which are not defined in either piece of primary legislation, but we take the term generally to refer to assets, not liabilities.

14. Although the 1972 Act power to amalgamate funds has not been revoked, it may be inadvisable to rely on that power alone to merge funds (or liabilities) given that it has no reference to post April 2014 benefits.

15. For these reasons and given the risk of challenge without a clear statutory power on this issue, we recommend that an opinion is sought from leading Counsel as to the scope of the 2013 Act powers.

16. The 2013 Act does contain regulation making powers by which the Secretary of State may change the person who is responsible for providing benefits under the LGPS (ie the administering authority).

17. In relation to the final question under paragraph 11 above, there is no express power to novate or assign contracts between administering authorities and third parties (whether admission agreements or supply contracts for services). The 2013 Act does contain a power for the passing of consequential, supplementary, incidental or transitional provisions by regulations. Thus, if it can be established that an appropriate power does exist in the 2013 Act to merge assets and liabilities, it may be that that power could be used to effect such reorganisation of contractual arrangements.

18. There are some recent precedents for reorganisation of LGPS assets and liabilities, relating to the abolition of the GLC and metropolitan councils under the Local Government Act 1985 ie under primary legislation.

Non-LGPS funds: application of Options

19. Since each of the schemes under consideration is governed by a separate trust deed and rules and not statute, like the LGPS, the investment and merger powers of those schemes are bespoke to each arrangement. Without further investigation as to the relevant trust powers, all that can be concluded is that there is no power to compel the trustees of these schemes either collectively or singly to invest in a CIV or to merge, either with each other or under a newly established scheme which might be established for LGPS funds.

7 Stage 2 funds

Background

Private sector – governance framework

In the private sector, the Trustee of an occupational pension scheme is a legally separate entity from that of its sponsoring employer or indeed any of the participating employers. The Trustee is the legal owner of the underlying assets but looks after those assets on behalf of the beneficiaries. The ability to pay beneficiaries' benefits, defined in a Trust Deed and Rules, depends on the resources of the scheme which are made up of the assets, the investment return on the assets and future contributions from the employer(s) and, if applicable, the members of the scheme. The employer's ability to continue making the contributions, i.e. its covenant, is therefore central to the security of the beneficiaries' benefits. The Trustee has a duty to collect the contributions, to invest the assets and contributions prudently and to help ensure that the correct benefits are paid to the right people at the right times. The trustee is therefore pivotal to the security of the benefits. Partly because of this, trustees are subject to much trust law (both pension and non-pension) and are heavily regulated. As a fall back, there is the Pension Protection Fund (PPF). However, the benefits payable from the PPF are typically lower than would be paid from the scheme.

Trustees in place for some time tend to build up a fairly strong pool of knowledge and skills. To help them, they appoint advisers. Trustees are required by law to appoint a scheme actuary, an auditor and investment manager(s). The funding must normally be agreed with the employer and the trustee has to consult with the employer on investment strategy. Ultimately, however, it is the trustees rather than the employer who have the final say.

Public sector – governance framework

In the LGPS, the administering authority for a fund (which is usually also the main employer) is responsible and liable for the benefit payments. The benefits themselves are guaranteed under statute; that is the payment of benefits does not depend on the state of the assets of the scheme nor the contributions paid into it by the employer. As a consequence, the interest of the members in the LGPS lies largely in the arena of service delivery and communication, rather than security of assets. The administering authority may, and usually does, delegate pension activities under s101 of the Local Government Act 1972 to officers and committee(s). Best practice guidance mandates the formation of a pensions committee, called the section 101 committee. Unlike the Trustee situation, the section 101 committee is not legally separate from the administering authority. The running of an LGPS Fund is arguably therefore a "buffer fund" which assists in budgeting and contribution smoothing because of its impact on the administering authority's finances. Although never tested in the courts, there is widespread belief that, as a fall back, the Government would be the ultimate guarantor for the benefits. To date, LGPS Funds have not been as heavily regulated as their private sector counterparts but this is gradually changing as strengthened governance of LGPS Funds is sought. Funds have to appoint an actuary and an auditor but the reporting mechanism and nature of the actuarial advice differs from private sector scheme arrangements. The officers are very much the 'executive' arm of any committee(s) but invariably decisions are made by committee following officer recommendations. The high turnover among members of committees makes it difficult for the knowledge and skill level to build up. Whilst an actuary and an auditor have to be appointed, funding and investment are ultimately the responsibility of the administering authority.

Changes expected to be made through current governance reforms are likely to reduce some of the differences between the running of a private sector fund and its LGPS counterpart.

Other funded public sector schemes

The spreadsheet of schemes identified by DCLG as falling to be considered in Stage 2 is included as Appendix 6A. We have traced information on 23 out of the 65 funds listed. A summary of our findings of the broad asset allocations for these funds is included in Table 19 below.

Table 19: Asset allocation of some other funded public sector schemes

Pension Fund	Equities %	Bonds %	Property %	Alternatives %	Value (£m)
BR (Railways Pension Scheme)	57	33	9	2	18,226
British Coal Staff Superannuation Scheme	68	17	7	7	9,105
Mineworkers Pension Scheme	66	19	10	5	10,960
The BT Pension Scheme	23	46	11	20	38,783
The Audit Commission Pension Scheme	0	14	0	86	662
Bank of England Pension Fund	0	100	0	0	3,122
The British Museum Company Ltd Ret Bens Plan	8	15	15	62	10
British Tourist Board Staff Pension Life Assurance Scheme	41	27	9	23	197
British Transport Police Railway Pension Scheme	53	17	9	21	76
British Waterways Pension Fund	57	43	0	0	308
Combined Nuclear Pension Plan (all sections)	40	35	10	15	678
Combined Nuclear Pension Plan (Closed section)	70	30	0	0	72
GPS Pension scheme (at 31/3/2012 before transferring to CNPP) in WEC/UAM/SLC	38	34	9	19	539
Nirex Pension Scheme (part of CNPP)	50	50	0	0	26
Environment Agency Active Fund	78	19	3	0	2,122
Environment Agency Closed Pension Fund	0	100	0	0	167
Financial Services Authority	48	45	6	0	484
Highlands and Islands Airports	58	42	0	0	71
Highlands and Islands Enterprise	61	39	0	0	64
Legal Services Commission No.4 Pension Scheme	45	52	0	3	352
OFCOM Staff Pension Scheme	16	22	0	62	249
PCPF	69	21	10	0	493
Student Loans	40	30	10	20	57
WEIGHTED AVERAGE/TOTAL	**41**	**38**	**9**	**12**	**86,824**

Feasibility of applying changes to these schemes

Since each of the schemes under consideration is governed by a separate trust deed and rules and not statute, like the LGPS, the investment and merger powers of those schemes are bespoke to each arrangement. Without further investigation as to the relevant trust powers, all that can be concluded is that there is no power to compel the trustees of the schemes either collectively or singly to invest in a CIV or to merge, either with each other or under a newly established scheme which might be established for LGPS funds.

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Appendix 1a Investment cost benchmarking CEM Benchmarking Inc.

The CEM approach

The CEM investment benchmarking survey and methodology has been developed over 21 years in conjunction with leading global pension funds. CEM captures the entire cost of investing the assets[6], including internal costs, investment manager fees and the cost of oversight and governance. Note that pension administration costs are specifically excluded from the analysis.

CEM takes great care to capture data consistently and accurately:

- They discuss the data collection process with all potential participants before starting
- They have a standard on-line survey that includes guidance on categorising data and that immediately identifies unusual or outlying data
- They discuss data issues with funds at length

They use defaults (typically peer or universe averages) where a fund cannot provide robust data.

The main drivers of pension investment costs are:

- Economies of scale (funds with more assets have a scale advantage)
- Asset mix (e.g. private equity is much more expensive than public equity)
- Implementation style (e.g. active is more expensive than passive management
- What funds pay relative to peer funds for similar assets and activities

CEM's Cost Benchmarking Methodology – gathering, collating and analysing the LGPS data

Detailed data was gathered from 18 LGPS funds (who volunteered their data) with combined assets of c£38bn. This Combined LGPS Fund Small is treated as a proxy for one of the five asset pools / merged funds under DCLG options 2 and 3. The combined costs for these funds were compared with a global peer group of 21 funds in the range £25bn to £45bn (median £35bn size, LGPS 6th in size). CEM calculated a Benchmark Cost for Combined LGPS Fund Small. The Benchmark Cost applies the median cost for each asset class from the peer comparators to the Combined LGPS Fund's actual asset mix. The effect is to neutralise the impact of asset mix differentials in the cost comparison. By comparing Combined LGPS Fund's costs with the Benchmark Cost it is possible to understand whether Combined LGPS Fund's costs are reasonable and to analyse why they compare the way they do.

As a proxy for a single asset pool, as included in DCLG option 1, the cost data for the 18 sample LGPS funds was used again but CEM superimposed the current actual asset mix for the whole of the LGPS to assets of £180bn. CEM recalculated a Benchmark Cost for this larger fund, Combine LGPS Fund Large in the same way. The 16 global peers for this comparison have assets in the range £67bn to £408bn (peer median size £101bn, LGPS 4th largest).

[6] All investment costs are included with two exceptions: transaction costs(related to buying/selling securities) and performance fees for private market asset classes (e.g. Private Equity, Real estate, Hedge Funds, Infrastructure). These costs are excluded because of historical difficulties in obtaining comparable data from participating funds.

Cost results

Combined LGPS Fund Small

Combined LGPS Fund Small's total investment costs were 57.5 bps (0.575% of total assets). This comprised direct investment management costs of 55.0 bps and oversight, custodial and other costs of 2.5bps.

The Benchmark Cost was 54.6 bps – so Combined LGPS Fund Large was 2.8 bps more expensive than the benchmark.

Table 20: Explaining why Combined LGPS Fund Small's costs are 2.8bps higher than Benchmark Cost

	Excess Cost/(Savings) £000s	Excess cost/(Savings) bps
Higher cost implementation style		
• Greater use of fund-of-funds	7,751	2.1
• Differences in the use of active management	(13,664)	(3.6)
• Higher use of external management	22,177	5.9
• Higher use of overlays	513	0.1
	16,778	4.5
Paying more than peers for similar assets/activities		
• External investment management costs	(7,120)	(1.9)
• Internal investment management costs	(217)	(0.1)
• Oversight, custodial and other costs	1,229	0.3
	(6,107)	(1.6)
Total	10,670	2.8

The 18 LGPS funds have higher costs because

- They use more fund of funds than the peer group
- They have less internal management and therefore use more external management than the peer group.

These higher costs are offset to some extent because the LGPS funds

- Have more assets managed passively than the peer group does
- Pay less than the peer group for external management.

Combined LGPS Fund Large

Combined LGPS Fund Large's total investment costs were 44.0 bps (0.46% of total assets). This comprised direct investment management costs of 41.5 bps and oversight, custodial and other costs of 2.5bps.

The Benchmark Cost was 40.6 bps – so Combined LGPS Fund Large was 3.4 bps more expensive than the benchmark.

Table 21: Explanation of why Combined LGPS Fund Large's costs are 3.4bps higher than Benchmark Cost

	Excess Cost/(Savings) £000s	Excess cost/(Savings) bps
Higher cost implementation style		
• Greater use of fund-of-funds	7,030	0.4
• Differences in the use of active management	9,840	0.5
• Higher use of external management	57,422	3.2
• Lower use of overlays	(16,060)	(0.9)
	58,233	3.2
Paying more than peers for similar assets/activities		
• External investment management costs	(18,210)	(1.0)
• Internal investment management costs	183	0.0
• Oversight, custodial and other costs	21,731	1.2
	3,705	0.2
Total	61,937	3.4

When the Combined LGPS Fund Large is compared to the larger peer group most of the same characteristics are observed as for the Small Fund. The notable difference is in the use of passive management. The LGPS fund uses less passive management than the peer group; larger funds have a higher allocation to passive management than the smaller funds. Some global research suggests that this is because of the diseconomies of scale that the largest funds experience and which increase the risk of moving prices against themselves when transacting in quoted equities.

Appendix 1b Detailed analysis of active to passive savings

Asset Class	Holdings (£millions)	Actively managed (£millions)	Passively managed (£millions)	Current Fees (£000)	Passive fees (£000)	Savings
Equities						
Asia Pacific	13,343	7,032	6,311	31,196	13,210	17,986
UK	49,406	24,162	25,244	101,538	19,268	82,270
Europe ex UK	15,146	7,934	7,213	20,413	20,296	117
US	17,490	8,475	9,016	28,814	10,319	18,495
Emerging Markets	8,835	6,131	2,705	56,391	19,790	36,601
Global	13,704	12,802	902	49,716	12,334	37,382
Total equities	**117,924**	**66,536**	**51,391**	**288,068**	**95,217**	**192,851**
Bonds						
UK	17,130	8,655	8,475	24,144	14,218	9,926
Emerging Markets	708	708	0	5,722	1,770	3,952
Global	5,783	5,783	0	25,835	4,800	21,035
Index linked	7,934	2,524	5,409	5,370	2,301	3,069
Total Bonds	**31,555**	**17,670**	**13,884**	**61,071**	**23,089**	**37,982**
Property	12,146	12,146	0	97,996	97,996	-
Alternatives	17,528	17,406	122	301,151	300,883	268
Cash				603	603	-
Total	**179,153**	**113,758**	**65,397**	**748,889**	**517,787**	**231,102**

Appendix 1c Components of transaction costs

Explicit transaction costs

Some transaction costs are said to be explicit because they do not depend on the trade price and are usually documented separately from it. They include brokerage commissions, market fees, clearing and settlement costs, and taxes/stamp duties all of which are generally known in advance, before the execution of the trade.

Commissions

Brokerage commissions are paid to intermediaries for executing trades. Although they differ from one intermediary to another, they are a fixed and visible component of transaction cost.

Market fees

Market fees are paid to trading venues for executing trades on their platforms. They are usually bundled into brokerage commissions for investors. These fees vary; on average, higher volume markets have the lowest costs. In recent years, competitive pressure has led to a significant reduction in these explicit costs.

Clearing and settlement costs

Clearing and settlement costs are related to the process whereby the ownership of securities is transferred. When the trading venue owns the clearing and settlement system, these costs, which are fixed and visible transaction cost component, are usually included in market fees. Like the latter, clearing and settlement costs differ from one trading venue to another.

Taxes/stamp duties

Tax rates or specific stamp duties are known in advance ; for example purchases of UK equities attract stamp duty of 0.5% of the purchase price.

Implicit transaction costs

Transaction costs are more than just brokerage commissions, market fees and taxes. The cost of a transaction depends on its size, the timing of the trade and the way in which it is handled. The impact of these factors is implicit in the trade price and cannot be known in advance. These implicit costs can be broken down into their components: spread, market impact and opportunity costs.

Spread

The spread is the difference between the best offer price (i.e. the lowest price at which the securities can be bought) and the best bid price (i.e. the highest price at which the securities can be sold).

Market impact

Market impact is the difference between the actual execution price for a transaction and the price that would have prevailed if the security had not been traded; in other words the amount by which the transaction moved the price.

Opportunity costs

The decision to trade and the actual trade do not usually take place at the same time. Market prices can move for or against the proposed trade. The opportunity cost is the loss (or gain) incurred as a result of the delay in completion of a transaction following the decision to trade.

Appendix 1d Transition test methodology

Background

In order to consider cost of transition for the LGPS, we asked two transition managers to estimate cost of change. The managers are experienced in the transitioning of LGPS assets and are aware of the portfolio distributions of institutional managers of UK mandates. Part of the instructions provided to the transition managers was to err on the side of prudence, which in this case means aiming to avoid an underestimate of the cost.

The transition was limited to listed securities, i.e. UK and global equities, which accounts for over 80% of aggregate LGPS assets. It is not feasible to transition property or alternative assets, e.g. private equity or other assets in closed funds.

The transition model

The legacy portfolio

Listed assets comprise 83% of aggregate LGPS assets, and are currently managed as follows:

- Approximately 23.5% of these assets are currently managed passively
- Approximately 12.5% of assets are currently managed internally, i.e. the securities are held in dedicated portfolios managed by personnel in the administering authorities
- The balance (47% of assets) are currently managed by external active managers.

The target portfolios

We asked the transition managers to consider the following transition scenario:

- The existing passively managed assets and internally managed assets would remain in place.
- All externally managed assets (c£84bn) would transition to passive management.

Asset allocation

We used the data as at 30 September 2013 from The WM Company as the basis for the asset allocation of “legacy” assets. In relation to the shape of the target portfolio we made the following assumptions:

- The shape of the allocation to equities (i.e. the proportions held in the UK and regional overseas equity markets remained unaltered.
- In relation to bonds, WM data showed a modest allocation to overseas index-linked bonds which we transferred to UK index-linked gilts and a modest allocation to pooled bonds which we transferred to UK fixed interest (a composite of gilts and corporate bonds).

Transition approaches

The transition managers’ approaches follow three stages:

1) Comparing the legacy and target portfolios, in order to determine overlap of securities (both by security name and the number held). These holdings will transfer in kind between the legacy and target portfolio and will bear no costs (other than custody costs of re-denomination)
2) Internal crosses within the transition management operation (e.g. with other clients). This includes dual listed shares, e.g. the legacy portfolio may hold US-listed depositary receipts which are essentially the US-listed clone of a security listed on another exchange.
3) Externally traded securities with execution normally conducted via programme trades and through brokered deals. Transition managers make extensive use of this type of dealing so broking commissions are set at

the lowest commodity level. Trades are executed efficiently to minimise market impact, i.e. avoiding the size of dealing affecting the dealing price. Clearly exchange costs and duties are unavoidable.

Provisos

- The cost estimate assumes that implementation of the transition is carried out as a single co-ordinated exercise.
- The process and timescale for the transition is designed to minimise costs; the volume of trades involved will require multiple tranches of transitions to avoid high market impact costs.

Analysis of test transition

UK equities

UK equities form the largest equity category. The transition manager made assumptions about the shape of portfolios of active UK equity managers (based on their knowledge of managers' portfolios from transitions they conduct and our breakdown of the largest managers of UK equity mandates for the LGPS and the proportions of assets they manage).

The transition managers estimated that approximately 60% of assets would be retained (essentially a nil cost transfer) and 40% of assets would need to be sold (and replacement holdings bought). Cost of trading of UK equities was estimated at £9.5 million (sell side) and £56.8 million (buy side). The high cost of the buy side is due to unavoidable stamp duty of 0.5% of the value of buy trades.

Overseas equities

The transition manager made assumptions about the shape of portfolios of active global and overseas equity managers mandates (based on their knowledge of managers' portfolios from transitions they conduct and our breakdown of the largest managers of these mandates for the LGPS and the proportions of assets they manage).

The transition managers estimated that just over half (approximately 53%) of assets would be retained (essentially a nil cost transfer) and approximately 1% of the balance can be transferred between overseas and UK holding (dual listing). That leaves approximately 46% of overseas assets to be traded externally. Cost of trading of overseas equities was estimated at £42.7 million (sell side) and £42.0 million (buy side).

Bonds

The bond transition involved a movement of approximately £17.6 billion of assets from active to passive mandates. For securities within these mandates, 32% of assets will be retained in the target portfolio. This leaves a net transaction of approximately £12 billion of buys and sells. The transition managers estimated a cost of £45 million for executing these trades.

Summary

The estimate for transition costs from external to active management was as shown in table 22 opposite.

Based on aggregate LGPS assets of £180 billion, where the amount of listed assets is approximately £150 billion, the transition cost would result in a transition "slippage" amounting to just under 0.12% of LGPS assets.

Table 22: Analysis of transition costs

Asset category	Transition cost £m
UK equities	90
Overseas equities	87
Bonds	38
Total	215

Potential variation in transition cost

It will be necessary to conduct further, more detailed, investigations of transition arrangements before any transition is conducted. This will include obtaining greater detail on the constituents of the current actively managed portfolios. Planning of the transition is vital. This will include elements such as phasing of tranches and timing between tranches.

In our financial analysis in Chapter 3, we have shown the sensitivity of financial outcomes, dependent on more prudent (i.e. higher) assumed transition costs.

Comments

- The cost of transition may seem significant as an up-front cost but it is actually no more than the hidden additional turnover costs incurred in active management which will be saved by investing passively for just one year.
- No additional funding or up-front cash is required from government or from local authorities. Transition costs are met from the assets of the scheme and would be reflected in asset valuations (like other investment transaction and turnover costs).
- Even allowing for other implementation costs, the payback period (i.e. the period over which savings from the transfer from active to passive management will exceed the cost of transition) is likely to be just over **one year**.

Appendix 2a Performance analysis

All of the Fund performance data used in this Appendix is based on aggregate WM Local Authority data from State Street Investment Analytics (The WM Company).

Performance and correlation

Overview

A summary of asset class performance is shown in tables 1 and 2. All performance is shown gross of managers' fees, but does reflect the cost of transactions and turnover. We provide additional information on each region and asset class in the following sections. General points to note include:

- In table 23, we have provided one, three, five and ten year performance to 31 March 2013. These represent a snapshot over time. There is overlap between these four time periods, e.g. the one year performance to 31 March 2013 is included in the all four figures quoted; the three year figures form part of the five year and ten year data.
- In table 24 we have provided performance for the four years to 31 March 2007, the two years to 31 March 2009 and the four years to 31 March 2013. This allows the analysis to show how Funds and markets performed going into, during and coming out of the financial crisis.
- Funds use a range of underlying benchmark indices. The indices shown in tables 1 and 2 provide an indication of relative performance; but will not necessarily reflect the benchmarks used by the underlying Funds; this is most notable for Global, Asia Pacific and Emerging Markets mandates, where a large number of benchmark indices exist.
- Each benchmark index operates with specific rules, e.g. treatment of taxes, timing of additions and exits from the index, approach to reinvesting dividends etc. Depending upon the specific rules, the index rules may not be practically replicated so would act as a headwind or they may create an opportunity to add value above the benchmark return (even if invested on a passive basis). As an example, UK pension funds can reclaim tax paid on dividends in some areas of the Pacific, whereas the index assumes that only dividends net of tax are reinvested. Typically, passive funds in the Pacific area can outperform the index by 0.2% p.a. purely on the basis of the tax reclaimable.
- The Funds' performance includes a combination of active and passive performance. It is reasonable to expect that asset classes with large allocations to active management would deviate further from benchmarks (in technical terms, have higher "tracking errors") than asset classes with large passive allocations.
- WM's data groups the Fund's conventional gilts and corporate bond holdings together, rather than separating them. In tables 1 and 2, we have shown the Funds' performance relative to both gilts and investment grade corporate bonds, reflecting the two main asset classes that are classified as "conventional" bonds.
- Funds may adjust their asset allocation from time to time. Depending on timing, this could have a positive or negative impact. To give an example, it would be possible for a Fund to outperform in every asset category but underperform its aggregate Fund index if its asset allocation positioning damaged returns to a significant extent (i.e. by being overweight in underperforming asset classes). The converse can also apply.

Table 23: Summary performance (performance shown gross of fees to 31 March 2013)

	One year %	Three years %p.a.	Five years %p.a.	Ten years %p.a.
UK equities	18.0	9.8	7.3	10.8
FTSE All Share	16.8	8.8	6.7	10.7
Relative	*+1.1*	*+0.9*	*+0.6*	*+0.1*
North American equities	19.0	11.4	10.5	8.4
FTSE North America	19.3	11.8	11.5	9.5
Relative	*-0.2*	*-0.4*	*-0.9*	*-0.9*
Europe ex UK	20.4	5.9	4.1	11.6
FTSE Europe ex UK	17.8	4.0	2.9	11.4
Relative	*+2.2*	*+1.8*	*+1.2*	*+0.2*
Japan	15.4	5.3	5.9	7.5
FTSE Japan	14.3	3.5	5.1	7.4
Relative	*+1.0*	*+1.8*	*+0.8*	*+0.1*
Asia Pacific ex Japan	*19.2*	*9.3*	*11.4*	*17.3*
FTSE Pacific ex Japan	*18.1*	*8.9*	*10.7*	*16.4*
Relative	*+0.9*	*+0.4*	*+0.6*	*+0.8*
Emerging Markets	10.5	4.3	6.8	17.1
FTSE Emerging	7.4	3.2	7.2	18.2
Relative	*+2.9*	*+1.1*	*-0.3*	*-0.9*
Conventional bonds	10.6	8.8	8.6	6.2
FTSE All Stocks	5.2	8.2	7.1	5.8
Relative	*+5.0*	*+0.6*	*+1.4*	*+0.4*
Conventional bonds	10.6	8.8	8.6	6.2
iBoxx Corp All Stocks	13.2	8.8	7.9	5.7
Relative	*-2.3*	0.0	+0.6	+0.5
Index-linked gilts	11.2	12.3	9.3	8.0
FTSE IL>5yr	11.8	13.0	9.1	8.3
Relative	*-0.5*	*-0.6*	*+0.1*	*-0.2*

Table 24: Additional performance (performance shown gross of fees to 31 March 2013)

	4 years to 31/03/07 % p.a.	2 years to 31/03/09 % p.a.	4 years to 31/03/13 % p.a
UK equities	21.1	-19.6	19.1
FTSE All Share	21.1	-19.3	18.3
Relative	*-0.1*	*-0.5*	*+0.6*
North American equities	10.0	-11.8	18.5
FTSE North America	10.8	-9.5	18.9
Relative	*-0.8*	*-2.5*	*-0.3*
Europe ex UK	24.7	-15.9	15.0
FTSE Europe ex UK	25.5	-15.6	13.6
Relative	*-0.6*	*-0.3*	*+1.2*
Japan	16.6	-15.2	11.6
FTSE Japan	17.0	-13.0	9.5
Relative	*-0.3*	*-2.4*	*+1.9*
Asia Pacific ex Japan	*26.7*	*-6.0*	*21.2*
FTSE Pacific ex Japan	*25.3*	*-7.5*	*21.2*
Relative	*+1.2*	*+1.7*	*-0.1*
Emerging Markets	31.6	-8.0	17.5
FTSE Emerging	32.9	-5.7	17.7
Relative	*-1.0*	*-2.4*	*-0.1*
Conventional bonds	4.0	1.9	10.7
iBoxx £ Overall	4.4	2.6	8.6
Relative	-0.4	-0.7	2.0
Index-linked gilts	5.6	4.9	12.2
FTSE IL>5yr	6.0	5.0	12.4
Relative	*-0.3*	*-0.1*	*-0.2*

Asset class and regional performance comments

Annual performance (12months ending 31 March of each year) and cumulative performance information are included later in this appendix (performance is shown for each asset class, relative to the underlying index over the past ten years). Points to note include:

- The Funds' information is based on aggregate performance. It does not show the level of dispersion between underlying Funds' and their managers' performance.
- Asset class performance has exhibited considerable volatility of recent years. This is reflected both in the absolute returns that have been generated, and in the relative returns.
- At a regional level, Funds' relative equity performance was poor during the build up to the credit crisis (2003-2007), with underperformance in UK, North America, Europe ex UK, Japan and emerging markets, and outperformance only being achieved in Asia Pacific. Part of this outperformance arises because funds can reclaim tax paid on dividends in some countries, whereas the benchmark assumes net dividends.
- Funds also struggled in the volatile markets witnessed during the credit crisis (i.e. 12month periods to 31 March 2008 and 31 March 2009). North America, Japan and emerging markets equities underperformed benchmark returns in both of these years and the UK and Europe underperformed in at least one of these years and over the two year period in aggregate.
- Over recent years there are signs of improved performance. Over the most recent 12 months, the analysis suggests there has been outperformance in the UK, Europe ex UK, Japan, Asia Pacific and Emerging markets. North American has continued to prove to be a difficult market for Funds to add value above the index.
- As a whole, Funds' index-linked gilts portfolios have struggled relative to the market return, under-performing in seven out of the past ten years and only outperforming in two years. There has also been underperformance in each of the three time periods shown in table 24 - reflecting the performance pre, during and post the financial crisis.
- Given the nature of WM's data, it is difficult to draw too many conclusions relating to Funds' conventional bonds. The WM data does not outline the precise mix of the underlying holdings are (they will be largely gilts and corporate bonds) or the proportions of assets that each category represents or the nature of these holdings e.g. duration, credit criteria, etc.

  Relative to the composite index (iBoxx £ Overall) that we have used in this appendix, Funds have tended to be overweight corporate bonds and underweight gilts; further, within corporate bonds, they have tended to be overweight in lower graded issues compared with the benchmark. This disposition explains benchmark outperformance in the last 4 years.

  We are also aware that Funds' corporate bond performance was very volatile during the credit crisis and the dispersion of returns achieved by Funds over that period was particularly wide.

Correlation analysis

The following three year Fund and index return correlations are shown below:

- Total equities (chart 2)
- Regional equities (chart 3)
- Bonds (chart 4).

Chart 2: Total equities

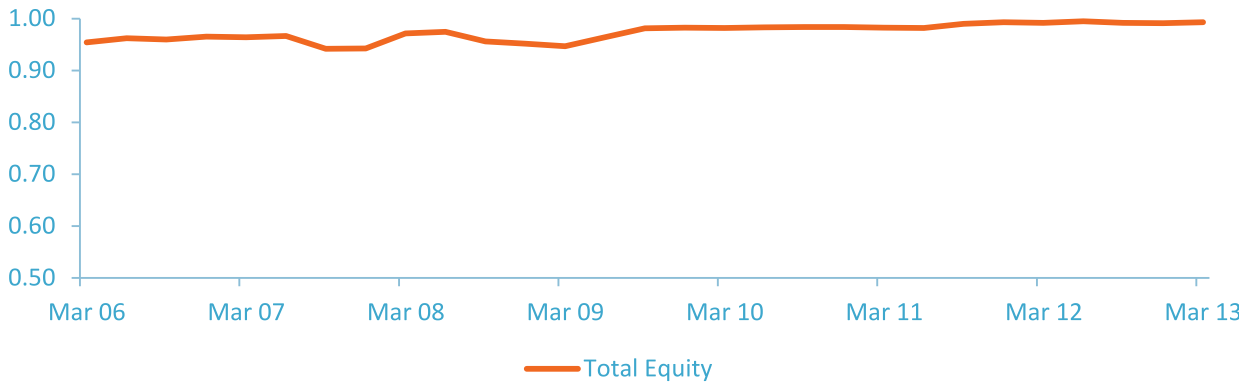


Chart 3: Overseas equities

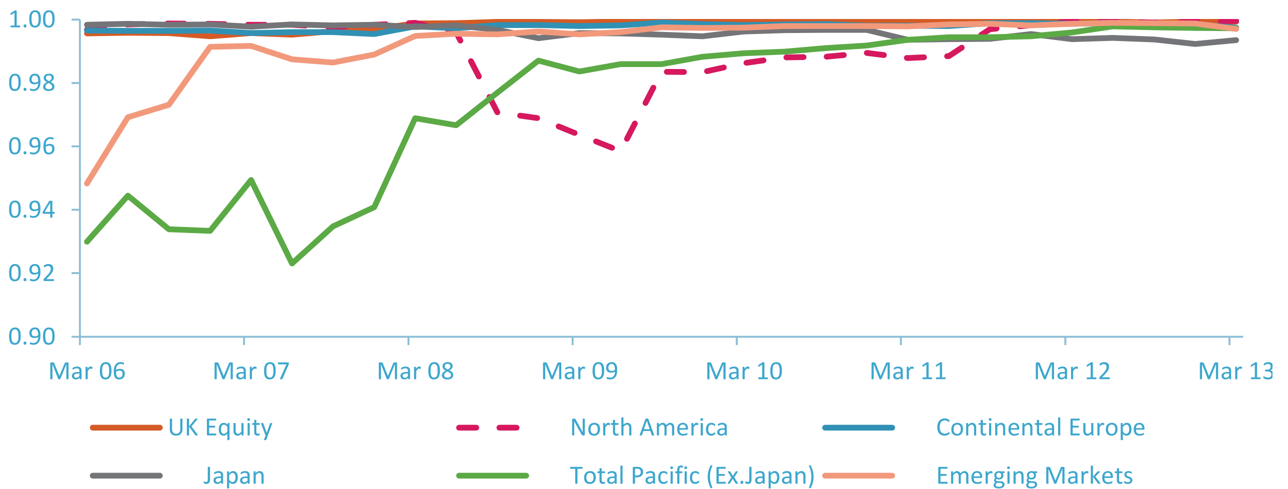
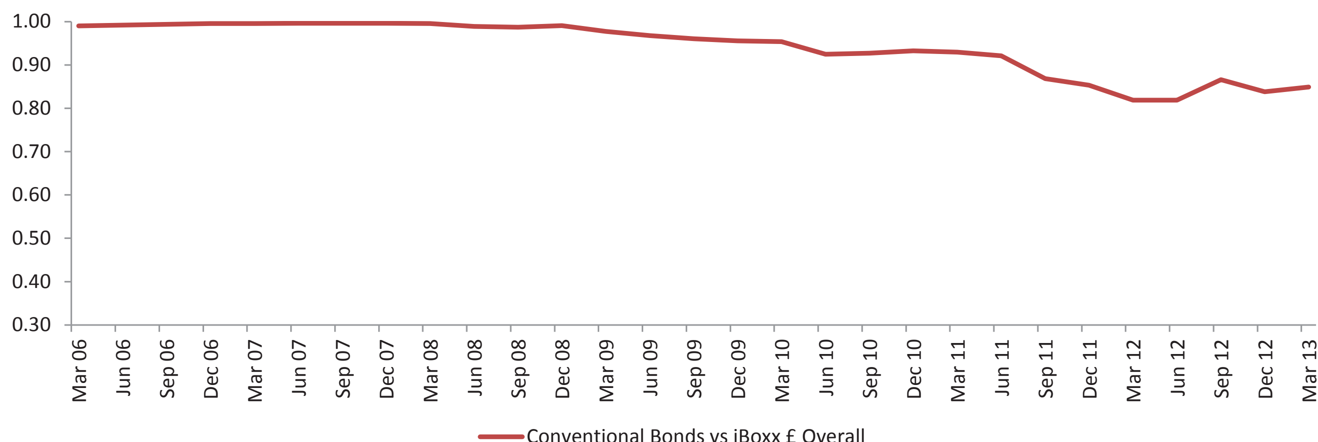


Chart 4: Conventional bonds and iBoxx £ Overall



- Correlation data provides an indication of strength of the relationship between the Funds' returns and underlying index returns. It does not provide any information of the scale of the relative moves. For example, even the returns of a highly active equity manager are likely to highly correlated with the broad market index, e.g. in excess of 0.8. Given this, we believe there are only limited conclusions that can be drawn from looking at the correlation data in isolation.
- The correlation of the Funds' aggregate equity returns, with the broad market index, tends to be very high (in excess of 0.9). This should be expected because:
  - There will be considerable overlap between the Funds' and index holdings, in particular the larger stocks that tend to be key drivers of risk and returns.
  - Regional equity markets tend to be highly correlated over time; therefore any regional differences between the Funds and the broad benchmark index should have limited impact on any correlation analysis.
- The correlation of the Funds' regional returns with the broad market indices also tends to be high. This is particularly notable for North American, Japanese, UK and European equities. This is again largely due to the high level of overlap between the Funds' and index holdings.
- Asia Pacific and emerging markets correlations tend to be lower than other regional markets. This is due largely to the more diverse nature of these mandates i.e. Funds use a number of different Asia Pacific and emerging markets benchmarks, each of which include different countries and stocks. These benchmark differences can have significant impacts on returns. Nevertheless, whilst the correlations are lower than other regions, they remain high, in excess of 0.9.
- Over recent years there has been a notable increase in correlations between regional markets and their underlying indices, suggesting that key drivers of the performances of Funds and indices are now more closely aligned.

In chart 4 we show the correlation of Funds' conventional bond returns, relative to an aggregate index (iBoxx £ Overall) of gilts and UK investment grade corporate bonds. As shown, the correlation has reduced following the Global Financial Crises as managers have moved underweight in gilts relative to the benchmark index and correspondingly overweight in corporate bonds, and more lowly-rated investment grade corporate bonds relative to the benchmark index.

Performance figures (12 months to 31 March, and 3, 5 and 10 years to 31 March 2013)

Chart 5: UK equities

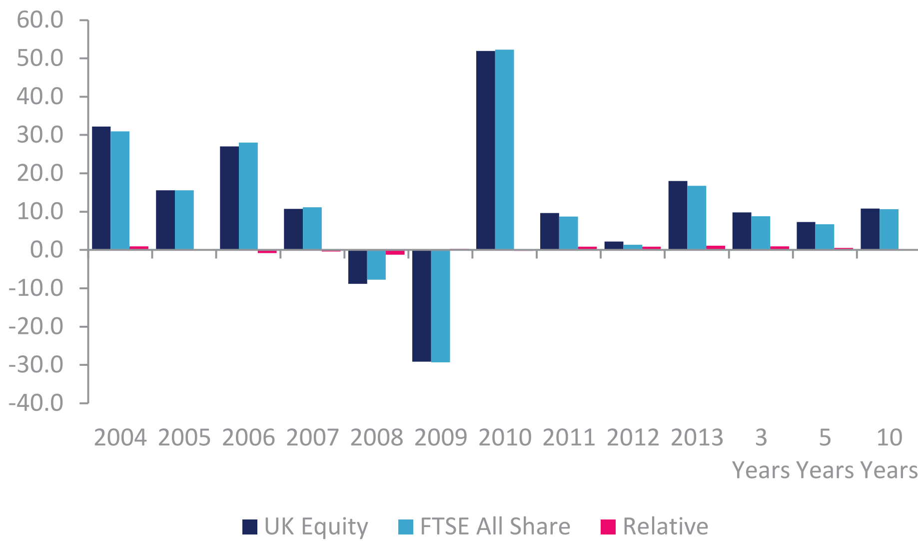


Chart 6: North American equities

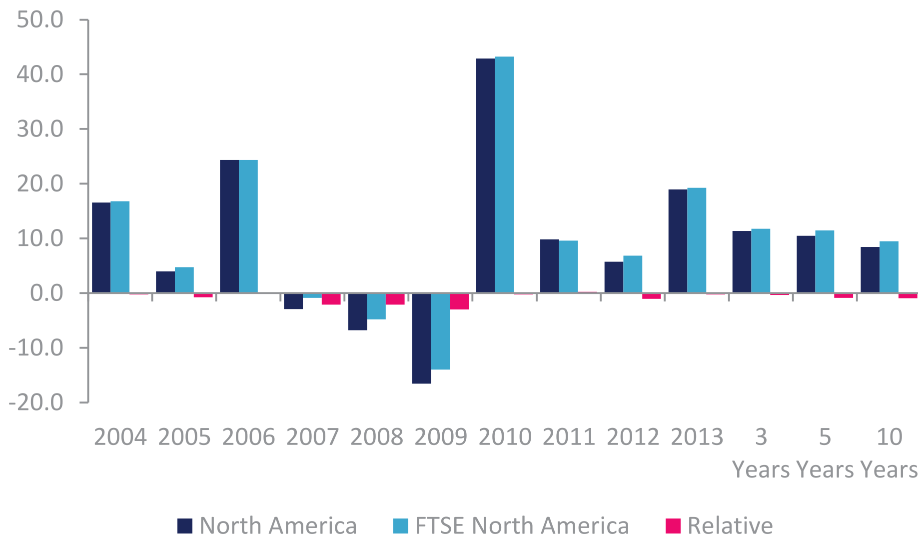


Chart 7: Europe ex UK equities

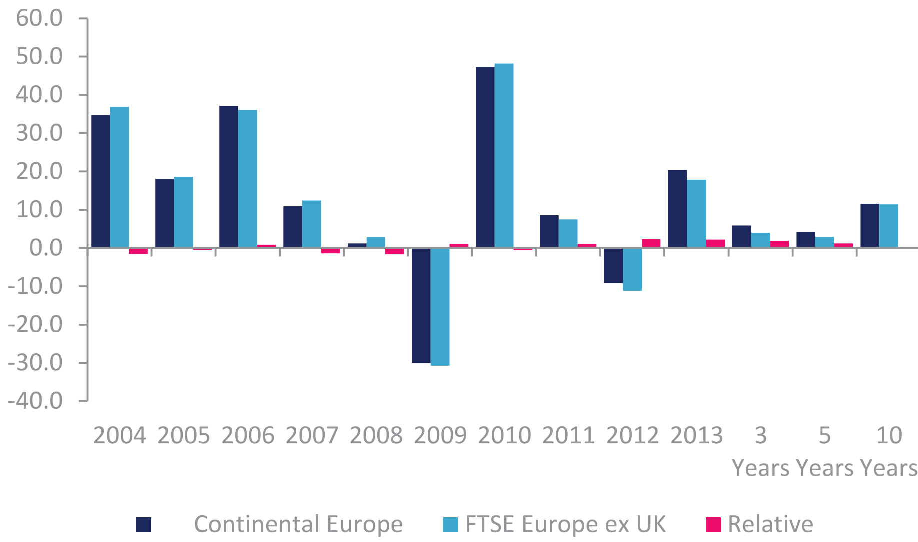


Chart 8: Japanese equities

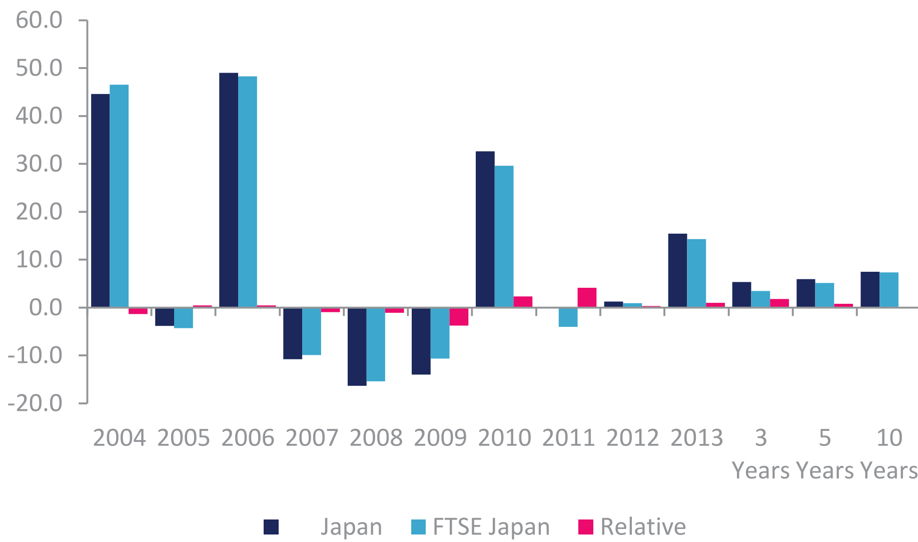


Chart 9: Asia Pacific equities

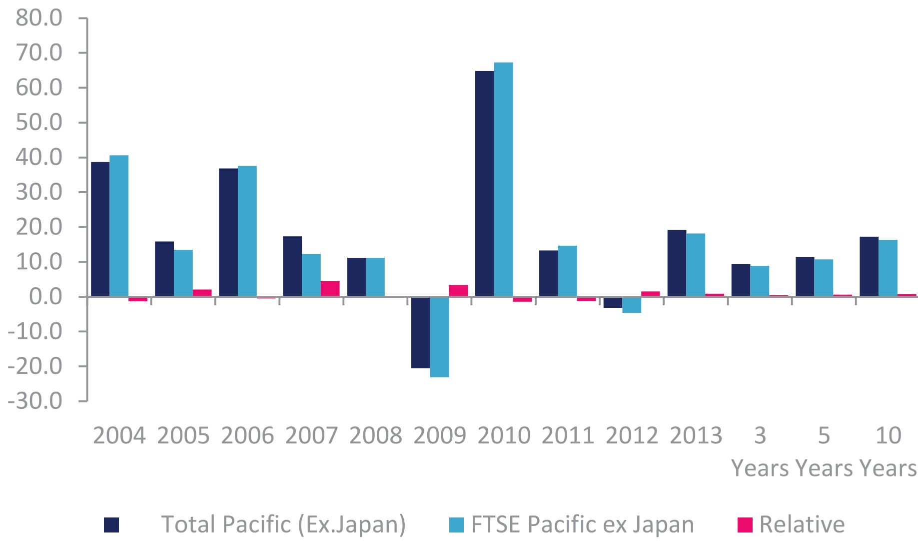


Chart 10: Emerging markets equities

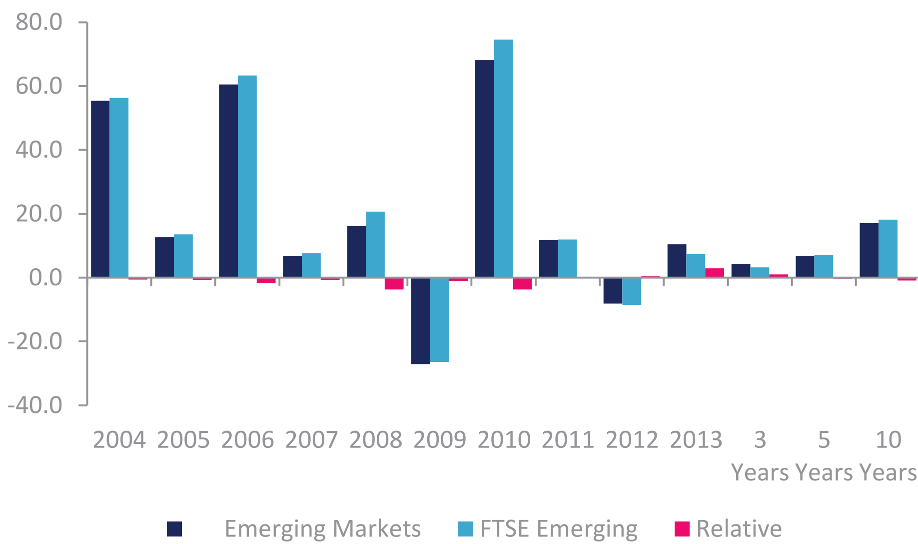


Chart 11: Conventional bonds versus composite UK bonds (iBoxx £ Overall)

Since mid-2009, funds have typically held less in gilts and more in corporate bonds than the benchmark index and have typically held lower grades of corporate bonds than the index

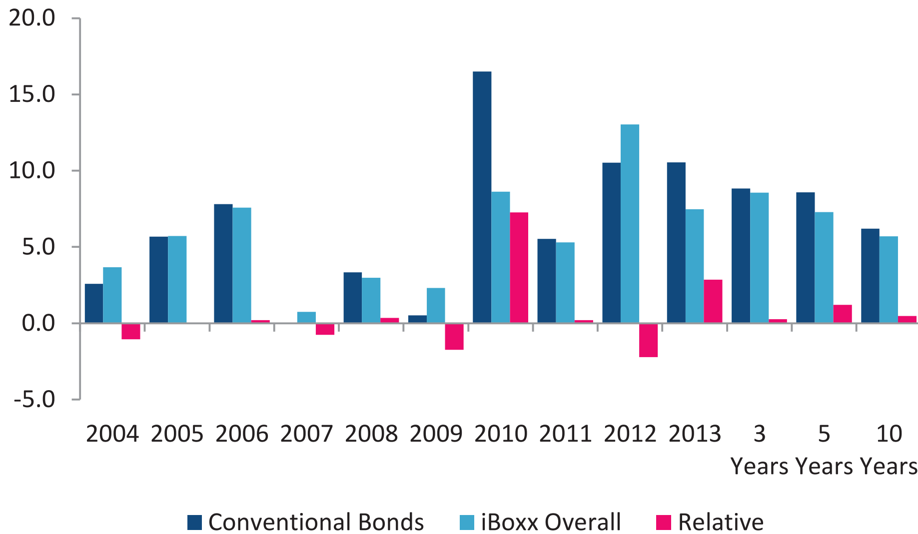
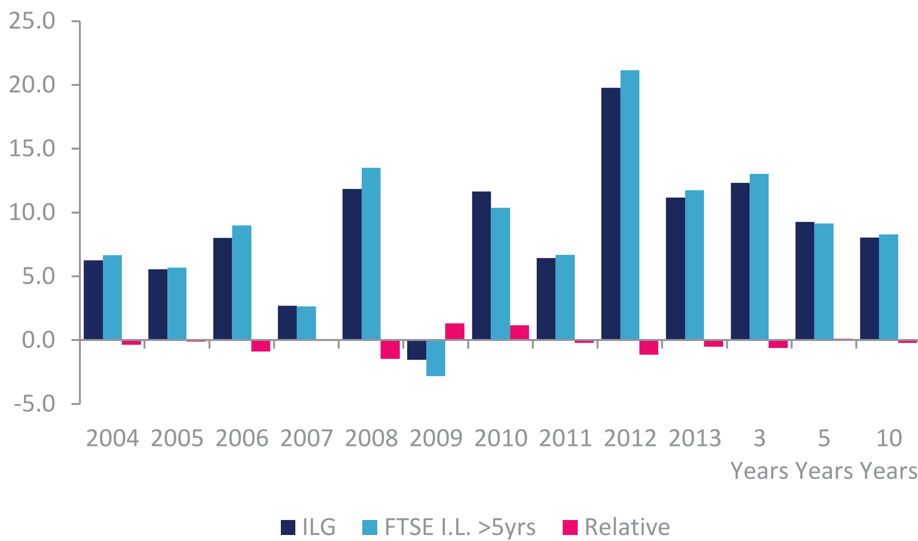


Chart 12: Index-linked bonds



Cumulative performance

Chart 13: UK equities

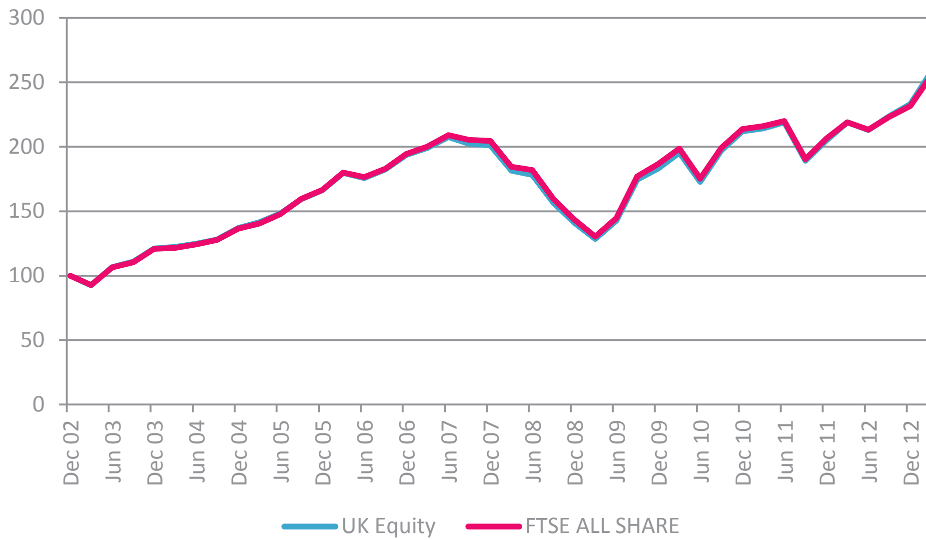


Chart 14: North American equities

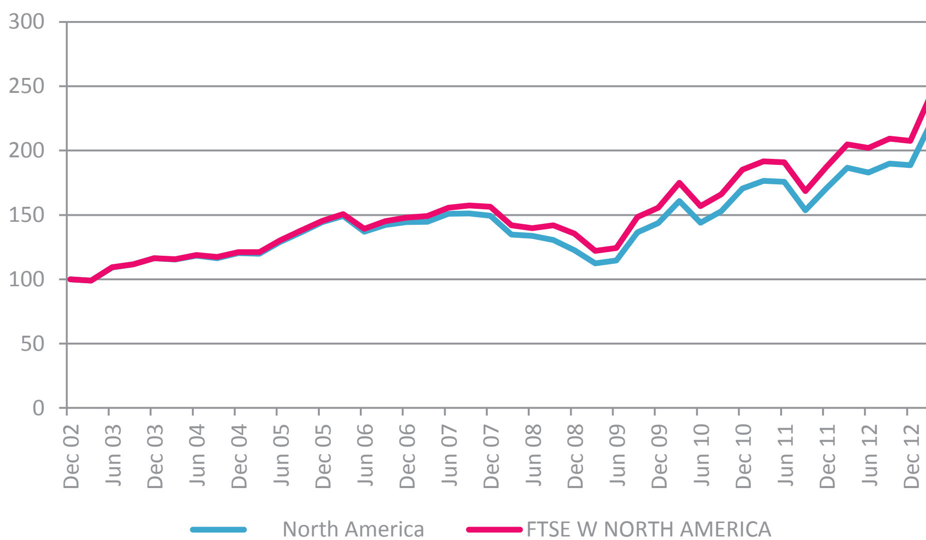


Chart A15: Europe ex UK equities

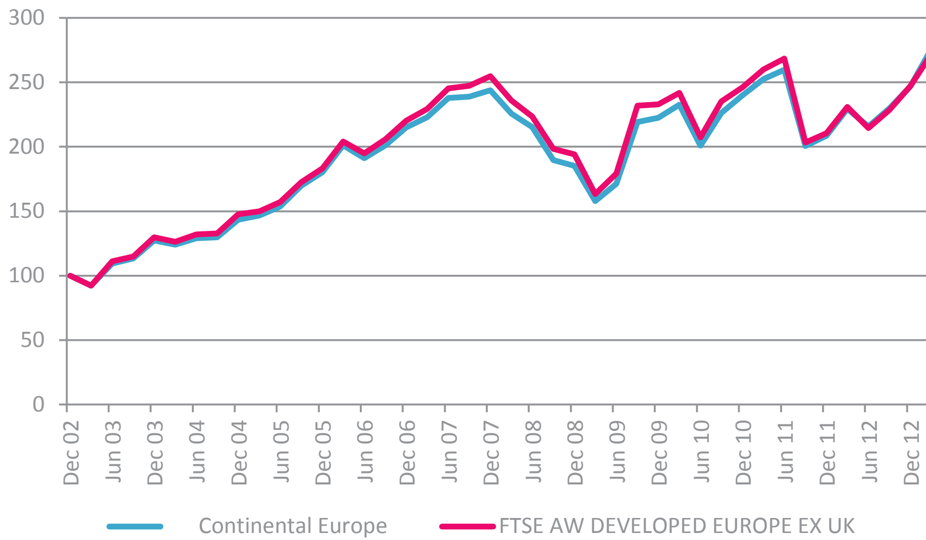


Chart A16: Japan equities

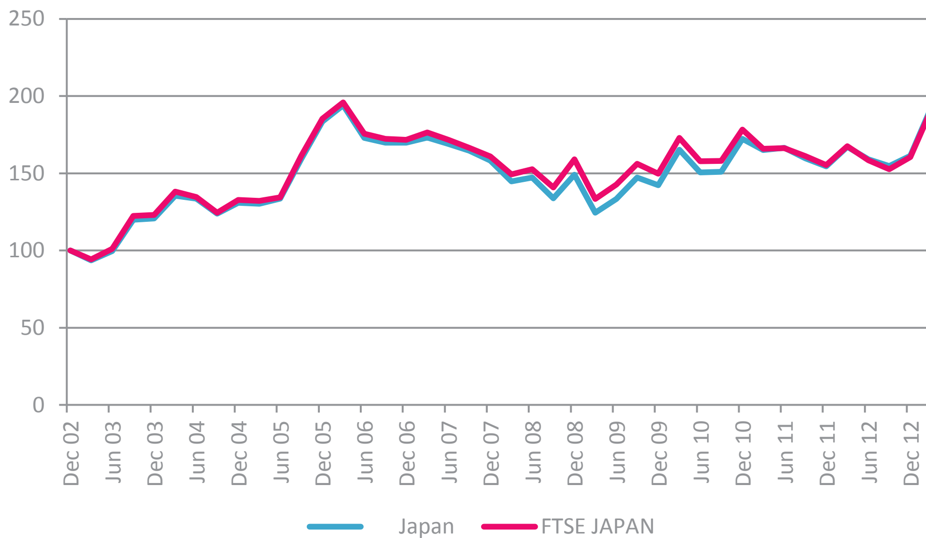


Chart A17: Asia Pacific ex Japan equities

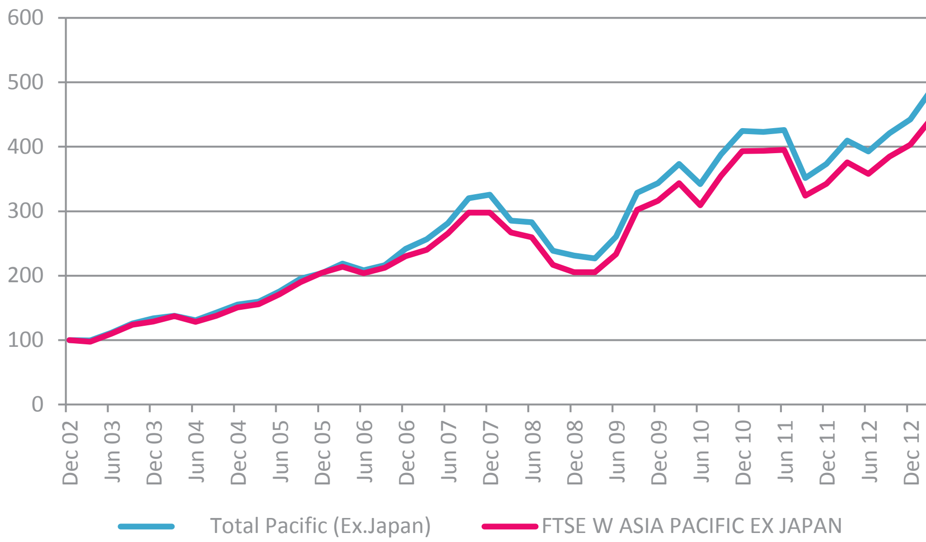


Chart A18: Emerging markets equities

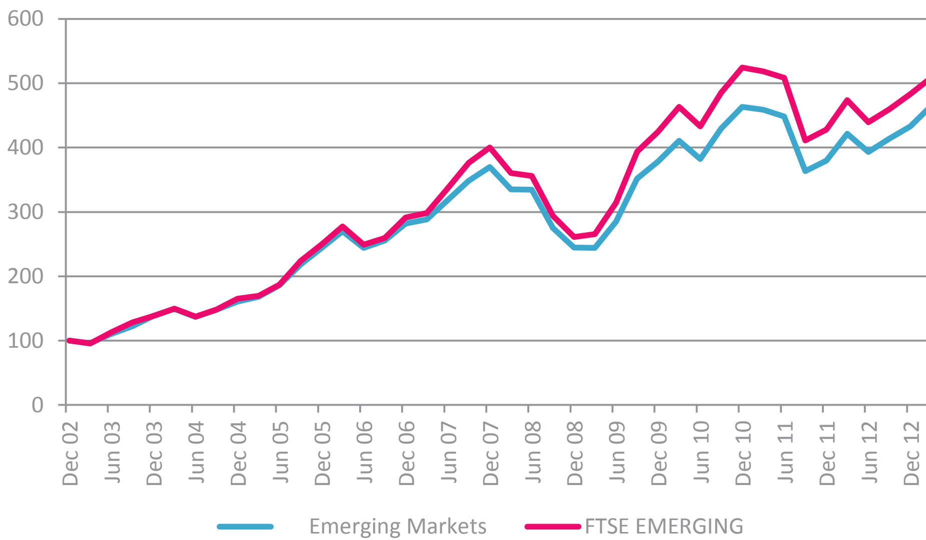


Chart A19: Conventional bonds versus government gilts and corporate bonds

Since mid-2009, funds have typically held less in gilts and more in corporate bonds than the benchmark index and have typically held lower grades of corporate bonds than the index

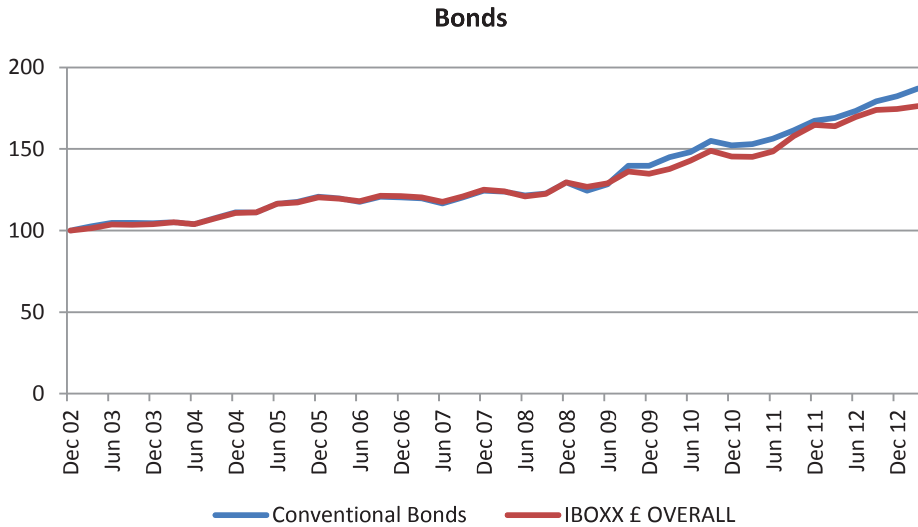
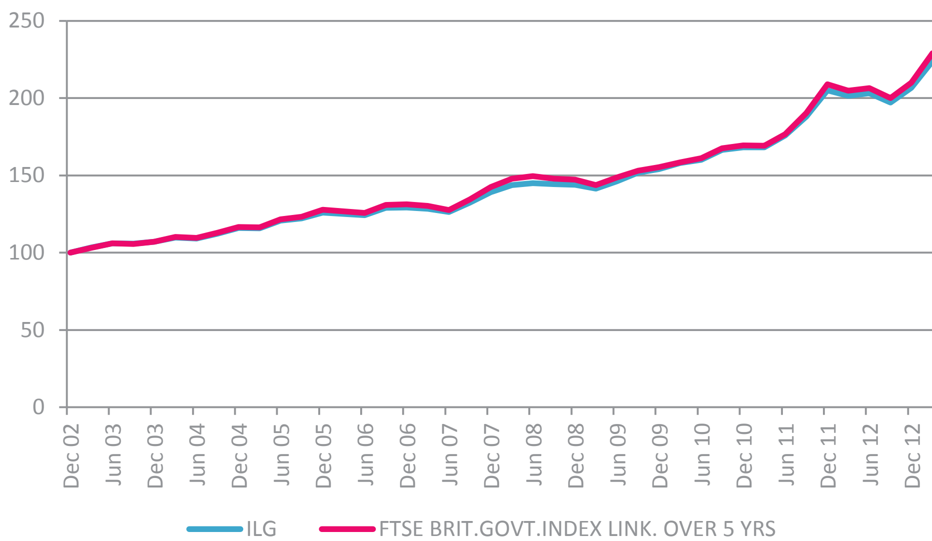


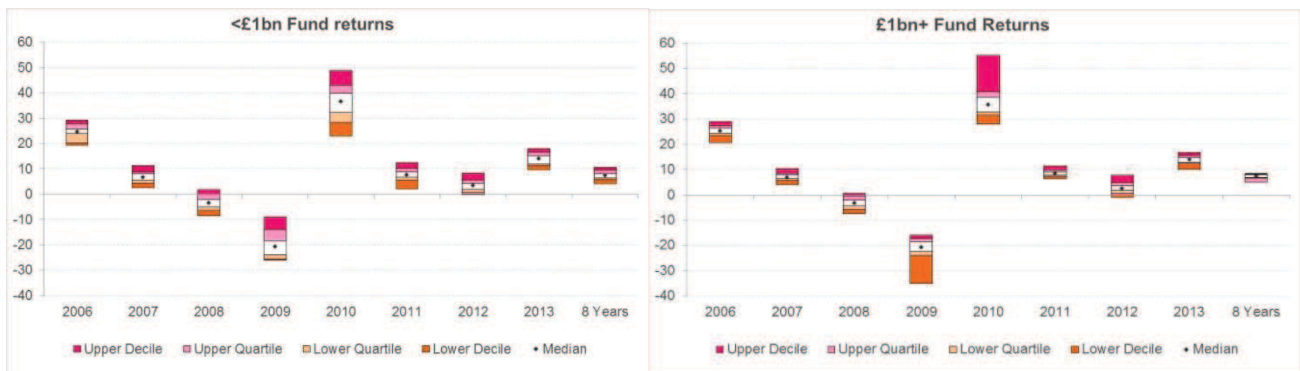
Chart A20: Index-linked gilts



Appendix 2b LGPS performance dispersion, small and large

All of the Fund performance data used in this Appendix is based on data gathered by Hymans Robertson from data in the public domain (e.g. Funds' annual reports and accounts).

The leftmost bars in each of the charts below shows the spread of returns in each financial year from 2005-06 to 2012-13, indicating the top 10, top quartile, median, bottom quartile and bottom 10. The rightmost bar shows the spread of returns for the cumulative 8-year period. The chart on the left includes all of the LGPS funds that are less than £1bn and the chart on the right is the funds over £1bn.



The median return over eight years for the smaller funds was 7.2% p.a. and for the larger funds it was 7.4%. Although there is no strong evidence of better performance by larger funds there is evidence of a wider dispersion of returns for the smaller funds, particularly in the critical years, 2008/09 and 2009/10 around the credit crunch.

Characteristics of funds in the top 10

- These funds use a limited number of managers (typically 1-3 managers with balanced mandates focused on equities and bonds);
- They retain their managers for the long term, even through inevitable periods of underperformance;
- They adopt a simple structure focused on equities, bonds and property;
- They make limited use of alternatives;
- Some use internal management; and
- There is evidence they rebalanced assets back to benchmark over 2008/09 as equity markets collapsed; this enabled full participation in the equity market rebound in 2009/10

Appendix 6a Analysis of available fund structures for one or more common investment vehicles Squire Sanders

1 EXECUTIVE SUMMARY

1.1 This section of our Report is in three parts:

(a) a legal analysis of the Investment Regulations and the restrictions contained in them on five English law CIV structures which may be held by LGPS funds;

(b) an analysis of the key regulatory and tax features of those CIVs; and

(c) a summary of the procurement and potential competition law implications of LGPS funds subscribing for investments in new CIVs.

1.2 A Glossary of terms used in the Executive Summary and the analysis is found at the end of Section 1. It should be noted that our conclusions are based on the law as it currently stands at the date of this Report. The law may and no doubt will change and evolve and therefore care should be taken to ensure our conclusions remain valid in that event.

Investment Regulations

1.3 The Investment Regulations currently constrain LGPS funds' investment powers by reference to some but not all of the available structures and do so by reference to the legal form of the vehicle. Those Regulations impose maximum holding limits of between 30% and 35% and may limit investments in other vehicles which are not expressly mentioned in the Regulations by virtue of a single holding limit of 10%. These limits can be repealed or amended by secondary legislation under powers given to the Secretary of State by the Superannuation Act 1972.

1.4 The power of investment of an LGPS fund is vested in the administering authority ("AA"). As such, since there is no power for another person, such as the Secretary of State, to exercise that function or direct how the power is used. AAs cannot be compelled to exercise their discretion to invest in a CIV (or any other instrument). The legislative means by which such a power could be given to another body is also by secondary legislation under the same Act.

Summary of CIV key features

1.5 The key features of each of the five CIVs (a Unit Trust (UT), Open Ended Investment Company (OEIC), Limited Partnership (LP), Authorised Contractual Scheme (ACS) and Unit Linked Life Fund) have been analysed on the assumption that new vehicles might be set up which could be tailored to LGPS funds (and any private sector funds which chose to invest in such funds). It may be that an existing insurance company could offer existing unit linked life funds or create new unit linked life funds for these purposes, which would save time and potentially capital, especially since three of the major players in the passive management field (Legal & General, BlackRock and State Street Global Advisors) each have current LGPS assets under management in such funds. We have not considered the implications of using existing vehicles in this Report nor have we carried out any due diligence on any such vehicles, so this is no more than a factual observation. There are also potential competition and procurement law issues which need to be addressed.

1.6 Because of the way that the Investment Regulations currently require OEICs to be authorised as UCITS compliant funds to maximise an LGPS fund's holdings in any single OEIC, we have assumed that only

such an authorised and UCITS compliant OEIC fund would be established. Although the regulatory régime is different, a comparable analysis necessarily applies to a unit linked life fund, because there is only one financial services model available.

1.7 The same regulatory hurdle of being UCITS compliant does not apply to the other vehicles (i.e. UTs, LPs or ACS), at least as far as the way the Investment Regulations restrict their usage. That is not to say that these vehicles can be used in a completely unregulated way, since the manager/operator and the depositary must be authorised under the AIFMD. The complexity of the financial services authorisation options for each of these vehicles is beyond the scope of this Report, but in summary, each collective investment scheme established under either section 235 or 235A of the Financial Services and Markets Act 2000 may be established on a number of different bases, broadly depending on the type of investor that the scheme is aimed at. UCITS may be marketed to retail investors but are accessible by professional investors also (i.e. including LGPS funds).

1.8 There are further categories of authorised fund which benefit from less rigorous rules which could be used for professional investors such as LGPS funds: these include the Non-UCITS Retail Scheme ("NURS") and the Qualified Investor Scheme ("QIS"). We have assumed for the purposes of this Report that the last of these vehicles, the QIS, is the most appropriate model to use for UTs, LPs and ACS, since it preserves the maximum flexibility and has the least regulatory burden. If further analysis of the UCITS and NURS options is required, we can of course revise our advice.

1.9 The broad parameters of our analysis are set out below; more detailed discussion is found in the table in the Annex.

1.10 There are, in the final analysis, a limited number of distinguishing features which would lead to the conclusion that a particular legal model is superior to the others.

(a) **Regulator** - under each CIV there is a need for authorisation under FSMA. For a unit trust, OEIC, LP and ACS the regulator will be the FCA. For unit linked life funds the prudential regulator, the PRA, supervises insurance companies. The life company regime is more complex than the supervisory regime for the other CIVs.

(b) **Timing** – whilst it is difficult to put an estimate on preparation time, the timescales for authorising an investment or fund manager are significantly shorter than establishing a new insurance company. Setting up a new unit-linked fund, however, involves comparable if not shorter timescales than for a new fund under the other structures. Use of existing vehicles (if appropriate) will of course reduce timing considerably.

(c) **Regulatory Capital** – regulatory capital requirements for life companies are significantly higher than for fund or investment managers. The regime is more complex and subject to change due to Solvency II in 2016 (with full implementation expected by 2019).

(d) **Ownership of the underlying assets** - of the five vehicles the OEIC and the life company vehicles each represent structures by which the legal and beneficial ownership of the underlying assets is separated from the investors (i.e. LGPS funds). In a UT, the trustee owns the assets on trust for the investors. In both the LP and the ACS legal ownership of the underlying assets remains with the CIV (because it has no separate legal personality from that of its investors). In all cases the CIV will contract with third parties through the operator of the CIV.

The retention of legal ownership under the LP and ACS models does not, however, mean that the investors control the underlying assets, since day to day control of the securities or other investments is a function which will need to be delegated to an authorised third party, ie a

custodian bank (called a depositary). Indeed, partnership law prevents limited partners from playing any part in management of an LP without losing limited liability status.

(e) **Tax transparency on the underlying assets** – The LP and ACS models are the only vehicles that have tax transparency as a key feature of their design. Separate regimes exist for authorised UTs and OEICs. A life company owns its assets and benefits from a general exemption from tax on its pension fund business.

(f) **Stamp Duty/SDRT** – All vehicles have favourable stamp duty tax treatment on transfers within the CIV. There is no distinction between stamp duty liability on purchases of equities and real estate by the CIV: all are subject to stamp duty although the initial transfer of securities into an ACS has been granted a specific exemption.

(g) **VAT** – Authorised OEICs have favourable VAT regimes with no VAT on management fees. Insurance services are VAT exempt and irrelevant to an internally managed unit-linked life fund in any event. The UT, LP and ACS models also have favourable VAT exemptions.

(h) **Withholding taxes (WHT)** - a detailed analysis of the efficiency of each vehicle to recover WHT on overseas investments is beyond the scope of this Report because it will depend on where the underlying assets are held. There may be differences in certain jurisdictions because of the recognition of the legal form of the CIV.

(i) **Counterparty risk**- a key consideration is what rights investors have in the event of insolvency of the provider/operator of the CIV since that is the counterparty (the insolvency risk attaching to underlying issuers of securities held by the vehicle is of course the same regardless of the vehicle). The only CIV that has a separate insolvency regime is that which applies to insurance companies, by which eligible policyholders are given priority over unsecured creditors. None of the other vehicles offers this preferential creditor status as the LGPS investor would be unsecured in the absence of express security being granted by the CIV (this would not legally be possible in an LP or ACS anyway, given that those vehicles have no separate legal personality) . In a UT, OEIC, LP or ACS where the assets are held by a depositary, the counterparty exposure is really therefore to the depositary holding the assets.

Note that the Financial Services Compensation Scheme is not available to LGPS investors.

(j) **Segregation of liability at a sub-fund level** – UTs, LPs and unit linked life funds do not offer segregated cells or sub-funds, meaning that the assets and liabilities of one sub-fund could suffer contagion if another sub-fund were to default. OEICs and ACS contractual schemes offer sub-fund options and segregation recognised under insolvency laws.

(k) **Investment objectives and restrictions** – because of the manner in which the Investment Regulations treat an OEIC (i.e. as a UCITS which has a maximum investment holding of 35% by an LGPS fund), that vehicle is disadvantaged in terms of its investment restrictions. Unit-linked life funds may only be provided on a regulated basis and so are also subject to permitted links rules which prescribe the assets that can be used to count against the solvency capital of the insurer. The UT, LP and ACS can all therefore benefit from more investment freedom than is prescribed under the UCITS directive.

1.11 **Procurement** – The potential concentration of assets under a new CIV or CIVs needs careful analysis to ensure that the procurement law impact of the establishment of new CIVs is not under-estimated. The identity of the operators of any new CIVs and the nature of the vehicles will determine these questions. We have therefore described in outline the parameters of public procurement by reference to the CIVs discussed in this Report.

GLOSSARY

ACD	**Authorised Corporate Director (of an ICVC or OEIC)**
ACS	**Authorised Contractual Scheme established pursuant to the ACS Regulations**
ACS Operator	**the person authorised under FSMA to manage an ACS**
ACS Regulations	**Collective Investment in Transferable Securities (Contractual Scheme) Regulations 2013**
AFM	**Authorised Fund Manager (meaning a legal entity authorised under FSMA to manage a fund)**
AIFM	**Alternative Investment Fund Manager (to be authorised by FCA effective 22 July 2014)**
AIFM Regulations	**Alternative Investment Fund Managers Regulations 2013**
AIFMD	**Alternative Investment Fund Managers Directive**
AUT	**Authorised Unit Trust (meaning authorised by FCA)**
CIS	**a collective investment scheme under section 235 FSMA (including OEIC, UT, ACS, UCITS and UCIS)**
CIV	**a CIS and unit-linked life fund or pension fund management insurance contract**
COLL	**FCA's Collective Investment Schemes handbook of rules and guidance**
Depositary	**the name for the custodian of the ICVC (FCA and/or PRA authorised)**
FCA	**Financial Conduct Authority**
FSMA	**Financial Services and Markets Act 2000**
Investment Regulations	**LGPS (Management and Investment of Funds) Regulations 2009**
ICVC	**Investment company with variable capital established pursuant to the Open-ended Investment Companies Regulations 1997**
LP	**Limited Partnership**
NAV	**Net Asset Value**
NURS	**Non-UCITS Retail Scheme (which can be either an ICVC or UT)**
OEIC	**generic name for ICVC**
PAIF	**Property Authorised Investment Fund, a regulated ICVC principally intended for property investment (structured as a NURS – not a UCITS)**

PRA	**Prudential Regulation Authority**
QIS	**Qualified Investor Scheme, being an FCA regulated fund for professional investors and not falling under UCITS or NURS regimes**
Solvency II	**the EU measures to enhance insurer capital requirements, governance and disclosure obligations**
Trustee	**the name of the trustee of a unit trust (FCA and/or PRA authorised) including a trustee of a UCIS structured as a trust**
TR13/8	**the FCA's report on unit-linked life fund governance**
UCIS	**generic term meaning Unregulated Collective Investment Scheme (falls within section 235 FSMA)**
UCITS	**ICVC or UT scheme meeting the requirements of the Undertakings for Collective Investment in Transferable Securities Directive (as amended)**
UT	**Unit Trust**

2 IMPACT OF THE INVESTMENT REGULATIONS ON CIV STRUCTURES

INTRODUCTION

The Investment Regulations impose, under Regulation 14(2) and Schedule 1, various restrictions on different types of investment vehicle. Those limits may be increased if the AA complies with Regulations 14(3) and 15. For the purposes of this report and all of the options, the collective investment vehicles ("**CIVs**") that most readily allow for pooling of assets are as follows.

Vehicle	Maximum Limit % of Fund
Limited Partnerships ("**LP**")	30%
UTs managed by one body	35%
OEICs managed by one body	35%
UT/OEIC managed by the same body	35%
Any single unit-linked or pension fund management insurance contract	35%

Notes:

1 The 35% restriction does not apply if the unit trust or OEIC invests, inter alia, in gilts.

2 An OEIC is defined by reference to the UCITS Directive, so an unauthorised investment company which does not comply with that Directive is subject to a separate lower limit which applies to unlisted securities of 15%.

3 In reality, a life insurance contract would have to be unit linked rather than a pension fund management contract as the latter is designed to be used for a discretionary investment management portfolio and would not be capable easily (if at all) of being issued in joint names of such investors.

4 All of the above limits apply at the time of the original investment. There is no comparable ongoing maximum requirement if, for example, the value of the holding increases by reference to other asset classes.

5 The Investment Regulations also make reference to the ability for LGPS funds to coinvest in a scheme approved by the Treasury under section 11(1) of the Trustee Investments Act 1961 "without any restriction as to quantity". To our knowledge only one such scheme has ever been approved (a CCLA property fund which holds approximately £80m of assets). We have not considered this apparently arcane power further as the regulatory framework is unclear.

3 IMPLICATIONS

3.1 The practical implications of the Investment Regulations remaining in place with the above limits for all three Options under consideration are as follows.

3.2 Notwithstanding the general power of competence under section 1 of the Localism Act 2011, the existence of the Schedule 1 limits operate as restrictions on LGPS funds.

3.3 The limits apply asset allocation limits (and thus diversification) by reference to legal vehicle types; they do not therefore directly apply to asset allocation by reference to, say, strategic allocation to global equities. Thus, it is possible to comply with the limits without diversification, e.g. a 100% listed equity portfolio which is directly invested only carries a single but separate holding limit of 10% in any one stock. However, even that limit is removed (by note 2 to the table in Schedule 1) if the investment is made by an investment manager appointed by the Authority and the single holding is in units of a unit trust.

3.4 Several forms of collective investment vehicle are not defined or listed expressly under Schedule 1. These include the new contractual co-ownership scheme model that came into force under theACS Regulations, although the limited partnership model available under those Regulations is, of course, already catered for. Other undefined vehicles missing from Schedule 1 and not otherwise defined expressly in the rest of the Investment Regulations include Luxembourg vehicles (SICAV, SICAR and FCP) and Irish common contractual schemes. All of these are used already by LGPS funds.

3.5 To the extent that such undefined vehicles do not fall within the named categories of restricted investments in Schedule 1, it may be possible to characterise them under an existing heading. This is the case for an ACS established as an LP. If there is no appropriate characterisation for an ACS established on a tenants in common basis[7], it may be capable of being held in an unrestricted way (as described in paragraph 3.3 above). There is an argument that such an ACS may, however, be subject to the 10% single holding limit. "Single holding" is defined in the notes to the table in Schedule 1 as "investments" [itself an undefined term]:

(a) in securities of, or in loans to or deposits with, any one body;

(b) in units or other shares of the investments subject to the trust of any one unit trust scheme; or

(c) in transactions involving any one piece of land or other property.

3.6 Given the novelty of the ACS as a vehicle (none has yet been established or authorised by the FCA) it is not possible to be definitive that, despite its clear status under section 235A of FSMA as a collective investment scheme (which clearly is an investment under any normal meaning), an ACS itself satisfies any of the above three categories which apply to single holdings. It would depend in large part on the form of the documentation constituting the ACS.

3.7 If an ACS can be constructed so as to avoid any of these single holding definitions applying, it would be necessary to consider whether the transparency of the vehicle means that the single holding test requires one to look through the ACS (which after all has no separate legal personality, so does not block a look through approach) to any underlying securities, units or land/property. If, in keeping with the approach taken elsewhere in the Investment Regulations, a look through is not necessary, it may be possible to invest in an ACS without limit.

[7] For the purposes of this appendix , references to an ACS are, unless otherwise stated, to a tenants in common structure.

3.8 The consequence of this requirement to categorise investment vehicles by legal type and whether or not the investment is listed or not will of course have a direct bearing on the number of different CIVs that an individual LGPS fund may invest in. The lowest number of CIVs that an LGPS fund may already currently invest in is three (using the 35% limit applicable to unit trusts, OEICS and life company funds).

Conclusion

3.9 In conclusion, it is possible to circumvent the limits and have an undiversified portfolio, with heavy concentration of asset and counterparty risk under the current regulatory framework. Whatever outcome is decided upon as a result of this Report, one key recommendation we would make is to reconsider the efficiency of the Investment Regulations in controlling risk, as the asset allocation limits in Schedule 1 do not do this in any sophisticated way and lead to additional expenses in many instances to use vehicles which circumvent Schedule 1 limits.

4 ANALYSIS OF CIV STRUCTURES

4.1 Leaving aside the maximum limits imposed by the Regulations, not all CIVs have the same governance, capital or tax features. A number of more fundamental complex factors are set out in the matrix in the table below. For instance, is it more important to have CIVs which have maximum investment freedom or is the governance and tax structure more important? Is it important for investors to own the underlying assets and not have to assert a contractual right against the CIV in the event of an insolvency of an underlying investment? Such questions need to be tempered by a realistic understanding of the legal rights on counterparty default.

4.2 We have not attempted to score the factors that we have identified as applying to each vehicle in terms of investor suitability but that could of course be done.

4.3 We have limited the analysis to those CIVs referenced in the Investment Regulations and the ACS alternatives. This is not because other CIVs are not eligible investments for LGPS, but simply because their treatment under the Investment Regulations is that the lower 15% investment limit applies for such entities if they have to be regarded as investments in unlisted securities (where the limit is 15% in aggregate) or the 10% single holding limit (unless they fall outside the Investment Regulations altogether).

5 IMPACT OF THE AIFMD

5.1 AIFMD was implemented in the UK with effect from 22 July 2013 by the AIFM Regulations. It effectively implements a new regulatory (EU-wide) regime for alternative investment funds, where previously regulation had either not existed at all or had focussed on certain activities of certain participants involved in the setting up and running of an alternative investment fund.

5.2 An AIF is very broadly defined in the AIFM Regulations. It includes all alternative investment funds other than UCITS. Therefore, it would include all of the CIVs considered in the Table, save for an OEIC established as a UCITS fund and a life company fund. The consequences of each of the non-UCITS funds falling within AIFMD's remit are that detailed new regulation of the vehicle, manager and third parties will apply (through FCA's "FUND" sourcebook) with effect from 22 July 2013. It is not possible to evaluate whether the costs associated with the new regime will outweigh those attributable to existing UCITS or life company regimes. The extent to which these new rules may cause significant extra cost will also depend on whether the supporting parties are AIFMD compliant at their own cost or whether AIFMD compliance becomes part of the set up cost of a new CIV.

5.3 There is a pension specific exclusion in recital 8 of AIFMD which provides that it "should not apply to the management of pension funds… [by] local governments and bodies or institutions which manage funds

supporting social security and pension systems…". This means that although AIFMD does not apply to the LGPS funds themselves, it does apply to any CIV which is not a UCITS (and not a unit-linked life fund).

6 PROCUREMENT LAW ASPECTS

Introduction

6.1 Public procurement of investment-related services will obviously add time and cost to the establishment of any new CIV. For that reason alone it is necessary to assess how the procurement rules apply, let alone the risk of challenge that either the procurement rules have not been applied properly or that they have simply been ignored when they should have been applied. This is a complex area of the law on which Counsel's opinion should be sought.

6.2 The administering authorities of LGPS funds are covered by the Public Contracts Regulations 2006 ("PCR") as contracting authorities. They are therefore subject to EU procurement rules. This means that, unless there is a relevant exemption in the PCR, the appointment of any new investment manager or the entering into a new investment arrangement requires a public procurement exercise to take place in accordance with those rules[8].

Application to investing in a CIV

6.3 There is, however, a widely used exemption in Regulation 6(2)(h) of the PCR which provides that, where a contracting authority enters into a contract which is: "for financial services in connection with the issue, purchase, sale or transfer of securities or other financial instruments, in particular transactions by the contracting authorities to raise money or capital", then no public procurement exercise needs to be followed. This exemption merely applies to the direct purchase of investments by a contracting authority, not where a discretionary investment management service is provided.

6.4 The word "securities" is not defined in the PCR, nor is it defined in the European Directive on procurement (2004/18/EC). However, the natural meaning of "securities" when used in other contexts is a wide one and we do not believe that it should be construed narrowly in a technical sense. Hence the fact that a unit trust, for example, does not issue shares, but units, should not be taken to mean that a subscription for units in a unit trust would not fall within the exemption. Shares issued by an OEIC are more obviously to be regarded as securities. Even if the relevant financial services contract is to purchase "other financial instruments", (a phrase which is also not defined) rather than securities, those words should be wide enough to capture unitised investments and would therefore apply to unit trusts as well as unit linked life assurance contracts.

6.5 In principle, we see no reason why this analysis should not also apply to the tax transparent forms of CIV, i.e. the limited partnership and the authorised contractual scheme established on a tenants in common basis. If all the AA is doing is buying an interest in such a CIV, the analysis should be the same as for the other forms of CIV, despite the fact that it is less clear that the limited partnership or ACS either issues or sells "securities" or "other financial instruments".

6.6 It is a completely separate consideration whether, notwithstanding any technical argument that Regulation 6(2)(h) removes the need for a procurement exercise on subscribing for interests in a CIV, it might nonetheless be desirable to do so in the interests of public transparency.

Services procured by and provided to the CIV

6.7 The legal structure and ownership of the CIV will determine whether it or its investors (i.e. the administering authorities of LGPS funds) are also involved in procuring additional services which are

[8] There is a general exemption which applies a de minimis threshold which would be irrelevant in the current circumstances, given the value of potential investments in a new CIV.

caught by the PCR. As stated above, the PCR only applies to public bodies which are contracting authorities. Therefore, this governance feature of the CIV is extremely important. If the operator of the CIV procures all of the external services and that operator is a private sector body, then the PCR will not apply to it and accordingly the full extent of public procurement rules will also be excluded. However, to the extent that the administering authorities retain control over the provision of services to the CIV via the governance structure of the CIV, there is a clear risk that each of the parties exercising that control will be subject to procurement rules. The services to be procured by a CIV could include those of a discretionary fund manager, the depository (custodian) and the administrator (if that is a different party from the depository), and other advisers such as auditors.

Governance/ownership issues

6.8 There is one other consequential issue which relates to the governance structure and who provides services to the CIV. This concerns the ability to apply "internal" or "in house" procurement exemptions, which derive a line of European Court judgements beginning with the Teckal case. This is a growing and developing area of the law which may also be affected by the new European Directive on procurement which is due to come into force in 2014. Without further understanding of exactly how a CIV might be established and the degree to which any private sector party might play a role in that structure is impossible to comment on the application of any such exemption, but a further analysis of the procurement implications may be necessary in due course.

7 STATE AID / EU LAW

State aid

7.1 Article 107 (1) of the Treaty on the Functioning of the European Union ("**TFEU**") establishes a general prohibition on State aid within the EU. A State measure will constitute State aid, and will in principle be prohibited, if it satisfies all four of the following criteria:

(i) The aid is granted by a Member State or through State resources;

(ii) The aid confers an advantage on the recipient by favouring certain undertakings or the production of certain goods;

(iii) The aid distorts or threatens to distort competition; and

(iv) The aid affects trade between Member States.

The four criteria are cumulative, i.e., all four must be met for the measure to constitute State aid. In the absence of any one of them, the measure is not classified as State aid pursuant to Article 107(1) TFEU.

7.2 Investment in the CIVs can therefore not give rise to State aid in the absence of an element of selectivity, i.e., the grant of a selective advantage within the meaning of the second limb of the State aid test (above). In addition, any selective advantage that could be identified would also have to be capable of distorting competition. In the scenarios envisaged, it is unclear whether any actual or potential competition in the market could be distorted. This would depend on the choice of an ultimate CIV model or models.

Fundamental principles of EU law

7.3 The implementation of Options 1 or 2 must not infringe fundamental principles of EU law, including in particular the prohibition on discrimination (Article 18 TFEU) and the free movement of goods, services, persons and capital within the internal market of the European Union (Article 26 (2) TFEU). Further detailed analysis may be required in order to ensure that the use of CIVs in practice does not give rise to potential claims that non-UK investment vehicles are suffering discrimination or exclusion in breach of these principles.

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Annex: Detailed Comparison of CIVs

Note: Please see Executive Summary for an explanation of why we have concluded that the Qualified Investor Schemes (QIS) model would be the optimum vehicle for each of the UT and ACS models, whether established (on an LP or tenants in common basis).

Criterion/Feature	UT (QIS)	OEIC	LP (includes LP ACS) (QIS)	ACS (tenants in common) (QIS)	Unit Linked Life Fund
Nature of Legal Structure (relevant to features such as ownership of assets, who contracts on behalf of CIV, who is able to sue/be sued)	Trust established by trust deed, entered into by the manager and the trustee. Established under trust law.	Corporate established by instrument of incorporation under the OEIC Regulations.	Partnership deed established under Limited Partnerships Act 1907 and COLL.	Contractual Scheme established by deed and COLL.	Corporate under Companies Act 2006 or alternative mutual structures.
Ownership of Assets	Assets owned by trustee. Investors have beneficial interest as unitholders. Trustee contracts on behalf of unitholders.	Assets owned by depositary. Investors are shareholders. ACD as director of OEIC enters into contracts.	Assets held by depositary. Investors are limited partners acting through general partner (GP) as legal owners. NB - Investors lose limited liability if they become involved in management.	Assets held by depositary; beneficially by investors as tenants in common.	Insurer is legal and beneficial owner of property and contracts with third parties. Investors have contractual rights as policyholders.

Criterion/Feature	UT (QIS)	OEIC	LP (includes LP ACS) (QIS)	ACS (tenants in common) (QIS)	Unit Linked Life Fund
AUTHORISATION ISSUES					
Collective Investment Scheme for FSMA purposes?	Yes	Yes	Yes	Yes	No
Which parties require authorisation by FCA?	Manager Trustee	Manager/ACD Depositary	Operator/Manager Depositary	Operator/Manager Depositary	Insurer (may delegate to separately authorised Manager).
Threshold conditions requirement for authorisation of Manager/Operator by FCA?	COND 2: Location of offices, effective supervision, appropriate resources, suitability, adequate business model	As UT	As UT	As UT	As UT, but additional life company authorisation rules apply.
Required personnel/ controlled functions for Manager/Operator.	Personnel performing controlled functions (e.g. director, investment manager, compliance officer, money laundering reporting officer) must be fit and proper (includes financial solvency, honesty and	As UT	As UT	As UT	As UT, although insurance company personnel will have different skill set requirements.

Criterion/Feature	UT (QIS)	OEIC	LP (includes LP ACS) (QIS)	ACS (tenants in common) (QIS)	Unit Linked Life Fund
	competence/ capability). Personnel to be in place on authorisation. Significant requirements on competence from regulators where advising / managing activities undertaken (effectively degree level plus ongoing CPD requirements).				
Does CIV (and any sub-fund) require authorisation?	No	Yes	Yes	Yes	Only at insurance company level but substantial regulatory oversight and attention (e.g. see TR13/8 thematic review by FCA into governance of unit linked funds).
Other authorisation features		Depositary must be independent of the OEIC (and the ACD).	Depositary must be independent of the Manager.	Depositary must be independent of the Manager.	Full regulatory oversight of capital, systems and controls and conduct of business.

Criterion/Feature	UT (QIS)	OEIC	LP (includes LP ACS) (QIS)	ACS (tenants in common) (QIS)	Unit Linked Life Fund
Timescales for CIV authorisation NB need to factor in time to recruit staff with appropriate qualifications for all CIVs if starting from scratch	Timescales extended depending on nature of QIS – can be 3-4 months.	As UT NB ACD authorisation likely to take longer as specific roles and responsibilities under COLL and OEIC regulations require specific expertise.	As UT	As UT	6 to 12 months from submission of completed FCA application pack, considerable preparation time, so 12-18 months in total.
Timescale for sub-fund from authorisation	4-6 weeks	As UT	N/A. No sub-fund permissible – need separate LP	As UT	N/A. In practice sub-funds operate at an accounting level only by the insurer creating separate sections of their pension fund management business.
Capital requirements for establishment?	**AIFM:** • Initial capital of at least Eur 125k; and • If value of assets under management greater than Eur 250m then additional own funds requirement equalto 0.02% of the excess over Eur 250m	**UCITS/NURS:** • Initial capital of at least Eur 50k/125k (if holding client money) or • Credit risk plus market risk calculation • Fixed overheads	As UT	As UT	Capital resources requirement made up of: • base capital requirement (between Eur 700k and Eur 3.7m) • risk-based capital requirements based on credit

Criterion/Feature	UT (QIS)	OEIC	LP (includes LP ACS) (QIS)	ACS (tenants in common) (QIS)	Unit Linked Life Fund
	(subject to a Eur 10m cap) • Own funds must not be less than 25% of annual expenditure • Own funds may be reduced by bank guarantee or PI insurance in certain cases.	25% relevant annual expenditure			risk, market risk, liquidity risk, operational risk and insurance liability risk
INSOLVENCY ISSUES					
Segregation of sub-funds' liabilities?	Umbrella schemes possible but not legally segregated at sub-fund level protection.	Protected cell regime provides that individual sub- funds can be legally segregated and protected from other sub-funds.	Not possible to have umbrella schemes, so no sub-funds segregation.	Umbrella schemes with sub-funds possible (see OEIC comments).	Segregation achieved at accounting level only.
Rights on Insolvency of CIV	Unsecured creditor	Unsecured creditor	Unsecured creditor (of underlying assets).	Unsecured creditor (of underlying assets).	Special creditor regime under Insurance Insolvency Directive gives policyholder preference over unsecured creditors.

INVESTMENT RESTRICTIONS					
Investment restrictions on the vehicle? **NB: Table contains a summary of the most relevant and important limitations for authorised CIVs (OEIC and life fund).**	There is a basic requirement for a spread of risk consistent with the investment objective and policy but there are no specific spread or concentration limits, except in relation to property. The following are permitted investments for a QIS: • Shares. • Debt instruments. • Deposits. • CISs. • Derivatives. • Contracts of insurance. • Government and public securities. • Property. • Precious metals (gold, silver and platinum). • Commodity contracts.	UCITS: • May invest no more than 10% of its assets in transferable securities or approved money-market instruments which are issued by any single body and all holdings in excess of 5% of its assets may not, in aggregate, exceed 40% of the assets. • No more than 20% of scheme property may be in transferable securities or approved money-market instruments issued by entities in the same group. • No more than 20% of assets may be invested in any one single CIS (UCITS or non-UCITS), with a general restriction of a maximum of 30% of assets invested in non-UCITS schemes.	As UT	As UT	Permitted links rules apply: • Must have in place appropriate valuation procedures • Permitted links must be via approved indices only Permitted links include: • Approved securities • Listed securities • permitted unlisted securities • permitted land and property • permitted loans • permitted deposits • permitted scheme interests • cash • permitted units • permitted stock lending • permitted derivatives

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		• Maximum OTC derivatives, counterparty exposure is limited to 5% (10% in the case of approved banks). • No more than 20% of assets may be invested in a combination of transferable securities and approved money-market instruments issued by, and deposits or OTC derivative transactions made with, a single body. • No more than 35% of assets may be invested in the government or public securities of a single body (subject to the point below). • Over 35% of scheme property may be invested in a single government or public securities body, but there is a restriction that no more than 30% of			Note: the terms above have specific meaning in the FCA glossary. The detailed rules are designed to protect policyholders.

		the scheme property consists of securities of any single issuer and a requirement that the securities must come from at least six different issuers			
VALUATION ISSUES					
Valuation rules for investor interests specified by FCA?	• The manager should exercise due diligence in connection with valuation and pricing, and show that it has complied with the minimum control requirements set out in the FCA rules. • The Manager has a duty to ensure that prices used to value investments are correct and to take action to rectify any incorrect (including reimbursing or compensating investors).	• See UT for valuation rules for specified investor interests. • Under the FCA rules, there is a set of minimum checks that a depositary must perform to satisfy itself that the ACD's pricing operation is adequately controlled and the risk of incorrect prices is minimised.	As UT	As UT	Specific insurance company rules relating to valuation of assets.

Valuation and Pricing of Assets	AIFM: at NAV Dual or single pricing Forward or historic pricing	At NAV Dual or single pricing Forward or historic pricing	At NAV Dual or single pricing Forward or historic pricing	At NAV Dual or single pricing Forward or historic pricing	At NAV Varied practices, including Forward or Historic pricing and priced on Dual or single basis FCA TR13/8 comments on pricing and valuation practices in unit-linked funds.
GOVERNANCE					
Governance Disclosure and reporting requirements	• Legal and regulatory reporting requirements. • A prospectus – must comply with COLL content requirements. • AFM must publish the annual reports and accounts within four months of the end of the fund's annual accounting period and the interim, or half-yearly, report and accounts within two months of the interim accounting date.	• Changes to funds subject to COLL rules which determine how changes should be treated, and as a consequence, whether they require approval of FCA, unit holders or notifications. • Materiality of their impact will determine whether the change is to be treated as a pre- or post-notifiable, significant (pre-event notification) or fundamental (shareholder vote)	As UT	As UT	PRA / FCA oversight of governance regime. Substantial PRA reporting and preparation of ongoing capital, solvency, investment and general corporate governance.

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	• Long and short form report requirements • Changes to funds subject to COLL rules which determine how changes should be treated, and as a consequence, whether they require approval of FCA, unit holders or notifications. • Materiality of impact will determine whether the change is to be treated as a pre- or post-notifiable, significant (pre-event notification) or fundamental (shareholder vote) change. • Regime for merger and winding-up subject to regulator consent	change.			
TAX ISSUES					
VAT Fund management charges	VAT exemption for management fees.	VAT exempt for management fees.	VAT exemption for management fees.	VAT exemption for management fees.	VAT exempt.

Stamp Duty/SDRT on unit/interest/share purchases	Schedule 19 Finance Act 1999 imposes a stamp duty reserve tax; - the tax is charged on surrenders of a unit in an AUT to the manager. Schedule 19 is to be abolished by the Finance Bill 2014 and the tax will be payable until then.	See UT	The Stamp Duty and Stamp Duty Reserve Tax (Collective Investment Schemes) (Exemptions) Regulations 2013 provides specific exemptions from Stamp Duty and SDRT for transfer units within an ACS and transfers of securities to an ACS.	As ACS LP.	No SDRT or stamp duty on life funds – no change in beneficial ownership.
Withholding tax at CIV level on overseas securities **NB Detailed analysis will depend on double-tax treaties to mitigate withholding taxes.**	The UT may be subject to non UK withholding tax on its investments in non UK equities and debt securities.	As UT OEIC is beneficial owner hence similar to life company and may be able to rely on double-tax treaties.	Tax transparent so should be able to rely on treaty relief, but will depend on recognition of vehicle's tax transparency.	Tax transparent so should be able to rely on treaty relief, but will depend on recognition of vehicle's tax transparency.	Life company as beneficial owner may be able to rely on some quite long standing double-tax treaties.

Appendix 6b Legal issues – option 3 Squire Sanders

1 INTRODUCTION/SCOPE

1.1 This section of our report identifies actual and potential barriers to merging LGPS Funds and to consider ways in which those barriers might be overcome. This analysis necessarily involves detailed construction of statutory language and therefore statutory powers. It should also be noted that the legislation governing the LGPS was not drafted with the original intention of facilitating a merger of funds so the construction of the language used needs also to be overlaid with an understanding of what the aim of Parliament was in agreeing on particular terminology in the way that it has.

1.2 Where we have concluded that additional primary legislation may or may not be required, that conclusion is necessarily based on our interpretation of statute, but our views could be challenged by other stakeholders. To add weight to the more complex areas of analysis we strongly recommend engaging leading Counsel to confirm our conclusions.

1.3 The mechanics of any merger of pension funds is a complex matter. However, the key dependencies are simply whether assets and liabilities can be transferred effectively, with the result that members' entitlements are kept whole and that there is a clear allocation of responsibilities before and, more importantly perhaps, after the merger. In the context of the LGPS where there is a complex inter-relationship between the roles of the Secretary of State, the administering authorities ("AA"), scheme employers, scheme members (to say nothing of third parties), these dependencies have many different aspects. The table in section [3] below summarises these dependencies but must be read in conjunction with the detailed commentary in section 4 below.

1.4 **Glossary of defined terms**

"AA" means Administering Authority

"Investment Regulations" means the Local Government (Management and Investment of Funds) Regulations 2009 (as amended)

"1972 Act" means the Superannuation Act 1972

"2008 Regulations" means the Local Government Pension Scheme (Administration) 2008 Regulations

"2013 Act" means the Public Service Pensions Act 2013

"2013 Regulations" means the Local Government Pension Scheme Regulations 2013

2 SUMMARY OF RESEARCH APPROACH

2.1 In order to establish whether the legislative framework would enable the Secretary of State to order the transfer of assets and/or liabilities from existing LGPS funds to other vehicles, it is necessary to confirm both the existence and range of the Secretary of State's current powers, as well as how those powers relate to the statutory responsibilities and functions of both administering authorities and scheme employers. In turn, this requires consideration of primary legislation covering both the existing LGPS benefit structure and that which will apply from April 2014 for each of these parties.

2.2 A variety of different business models could be used as the receiving entity for a fully merged new fund structure, although there are "political" as well as legal drawbacks with using any of the existing LGPS AAs' funds as such a vehicle, given that they were established to cover specific geographical areas (regardless of the political issues associated with local accountability and different funding levels) and

the statutory alignment of funds to AAs is set out in primarily legislation so can only be amended by further primary legislation.

2.3 It is important to distinguish between the terminology here: the body that is responsible for discharging the benefit obligation to the members (i.e. the AA) has a fund" or "funds" which is designed to be sufficient to do so. The AA has an obligation to invest the monies it receives and can do so, subject to the Investment Regulations, in a range of different vehicles or directly. The "fund" is therefore separate from the underlying investment vehicle and is an asset owned by the AA. In turn, the power of investment (and in fact duty to do so) is vested in the AA for its fund; it does not belong to nor is it delegated by the Secretary of State.

2.4 The key issues relate to whether:

(a) the assets supporting current liabilities can be transferred under the control of other AAs or new statutory bodies; and

(b) whether scheme liabilities may be transferred in the same way.

2.5 In turn this leads to the following questions:

(a) does the Secretary of State have the power to compel mergers of assets and liabilities within existing vehicles only or would it be necessary and/or desirable to create new funds and/or AAs?

(b) if the Secretary of State does not have the requisite powers and primary legislation is necessary, is there a suitable precedent that exists?

2.6 It is also necessary to look at other powers than those which govern the mere transfer of assets and liabilities. These include the degree of prescription which applies to current AAs under the existing LGPS and how scheme employers are mandated to adhere to a particular one of the 89 current LGPS Funds.

2.7 If the Secretary of State does possess the above powers already, or can reserve them to himself by means of making new regulations made under existing primary legislation, the next level of analysis is whether third parties, whose rights and obligations are not expressly covered under the statutory framework, can also have their obligations and rights transferred or assigned to apply to a new structure. We consider each of those issues in turn.

3 SUMMARY OF LEGAL DEPENDENCIES

Pre-condition to merger of funds	Pre-2014 legislative power (Primary or Secondary)	Post-2014 legislative power (Primary or Secondary)	Potential Legislative solution
Establishment of new Fund and new Authority	N/A	Section 3(1), 2013 Act	Regulations
Alignment of statutory functions of Act and requirement to maintain a fund	The "Appropriate Fund" is designated by Regulation 29 and Schedule 4 of the 2008 Regulations	Regulation 53 and Schedule 3 of the 2013 Regulations identify the bodies who are required to maintain a pension fund and are therefore AAs	Regulations - would be required to amend these provisions if the AAs were to change.
Allocation of employers to the new fund	The "Appropriate Fund" is designated by Regulation 29 and Schedule 4 of the 2008 Regulations	Scheme employers are designated by Part 2 of Schedule 4 of 2013 Regulations	Regulations -would be required to amend these provisions if scheme employers were reallocated.
Transfer of existing fund (assets only) to new Authority	"Amalgamation" under Schedule 3, (Para 2) 1972 Act	Section 3(1), 2013 Act and Schedule 3 Broad power to make regulations in relation to schemes - not specific	Regulations
Transfer of past liabilities to the new Authority	"Amalgamation" under Schedule 3, (Para 2) 1972 Act	Schedule 3, paragraphs 11 and 12 of the 2013 Act permits regulations for administration, management and winding up and for nominating who must provide benefits.	TBC. Regulations may be made by the Secretary of State
Novating existing admission agreements and supplier contracts (these will include the current AA as a party)	N/A [*Existing Admission Agreements saved by Transitional Regulations*]	Section 3(2) 2013 Act consequential etc power, may be sufficient.	Regulations would be needed to novate all admission agreements wholesale and any supplier contracts to the new fund.

4 POWERS TO FACILITATE THE MERGER OF LOCAL GOVERNMENT PENSION FUNDS

4.1 The 1972 Act gives the Secretary of State the power to make regulations to provide pension arrangements for persons employed in local government service. Regulations were subsequently made to confirm the then applicable and subsequent benefit structures.

4.2 The 2013 Act (which applies to all public service pension funds, not just the LGPS) changed the benefit structure for the LGPS from 1 April 2014 and created new powers in respect of contributions from scheme employers and employees, albeit that those funding powers largely replicated the 1972 Act powers.

4.3 It should be noted that the investment powers of the LGPS funds have not been changed by the 2013 Act, so the only powers and duties AAs have are given under the 1972 Act.

4.4 This means that there is no pre and post 2014 distinction between the funds held by the AA and the benefit obligations due to the members. Where an AA decides to use its statutory powers to establish a separate fund for particular employers by virtue of Regulation 32 of the 2008 Regulations and/or Regulation 54 of the 2013 Regulations, it is within the AA's discretion to do so. This is the only mechanism by which liabilities for particular employers are separately identified and hypothecated. The legislation does not operate so as to ringfence the affected members' rights to benefits[9].

4.5 This principle is reinforced by the language of Regulation 86 of the 2008 Regulations (mirrored in Regulation 103 of the 2013 Regulations) which makes it very clear that any given member is to be identified, for funding purposes, as having an "appropriate fund".

4.6 A further nuance of this lack of correlation between a member's benefits and funding is that while the benefits are effectively guaranteed at the level of the LGPS as a whole, the rights of the member can only be asserted against the responsible AA for the relevant fund. For example, a member who paid contributions to a London borough fund cannot bring a claim against a metropolitan AA (and nor can the London borough fund itself). As evidence of this principle see Regulation 96 of the 2013 Regulations ("*the relevant transfer (to another scheme) may only be paid by the administering authority from its pension fund*"). This issue was examined in a judicial review brought by South Tyneside Metropolitan Borough Council where it was held that liability of the employer to contribute to a deficit in the Northumbria CC Pension Fund had not been transferred as a result of a restructuring (see further below).

1972 Act powers: detailed analysis

4.7 The general power to establish superannuation schemes for employees in local government service is set out in section 7 of the 1972 Act in the following terms:

"The Secretary of State may by regulations make provision with respect to the pensions, allowances or gratuities which, subject to the fulfilment of such requirements and conditions as may be prescribed by the regulations, are to be, or may be, paid to or in respect of such persons, or classes of persons, as may be so prescribed"

This power does not appear to place any limits on the scope of regulations that may be made under the Section 7 power. In fact, virtually all of the secondary legislation passed for the purposes of the reorganisation examples we cite below, was made under this Section.

4.8 Notwithstanding the power in Section 7, Schedule 3 of the 1972 Act details the specific provisions which may be included in regulations for local government pension arrangements.

(a) Paragraph 2 of Schedule 3 provides that:

"Regulations may [provide] for the establishment and administration of superannuation funds, the management and application of the assets of such funds, the amalgamation of all or any of such funds, and the winding-up, or other dealing with, any such fund."

The terms "amalgamation" and "winding-up" are not defined in the 1972 Act and do not appear to have been considered further by the Courts in this context, nor has the definition been clarified in other legislation. Consequently, we have to apply an ordinary construction to those words. The word "fund" is not defined and would, we suggest, normally refer to the assets only of the relevant arrangement, without including the concept of the liabilities. This is a vital point

[9] **As an aside, members' rights to benefits are not hypothecated by reference to particular assets(with the exception of AVCs) although even where, legally, any money purchase AVCs will be held in the name of the AA, not the member.**

of construction and is not free from doubt. However, because benefits are guaranteed and not dependent on a given level of funding, there is no reason to suggest otherwise.

"Amalgamation" would suggest the merger of such funds, and "winding-up" would, in our view, generally imply termination of a fund. Whether such a winding up would necessarily include a discharge of liabilities is not clear from the context. We would suggest, for the reasons given above that there would have been no need to specify that a discharge of liabilities would necessarily follow on the exercise of the power, given that, again, from the member's point of view, the benefits are guaranteed.

Notwithstanding this uncertainty, the specific enabling power in paragraph 2 of Schedule 3 is also very broad, particularly in the phrase "or other dealing with" which would imply any other action the Secretary of State may wish to take, subject to the general principles that statutory functions and discretions can only be exercised within the judicial test colloquially known as "Wednesbury reasonableness", established in Associated Provincial Picture Houses Ltd v Wednesbury Corporation [1948]. In that case the judge held that "*if a decision on a competent matter is so unreasonable that no reasonable authority could ever have come to it, then the courts can interfere.*"

(b) Paragraph 3 of Schedule 3 specifies provisions relating to the transfer of benefits:

"Regulations may [provide] for the payment and receipt of transfer values or in lieu thereof for the transfer or receipt of any fund or part of a fund or policy of insurance".

We understand the reference to the payment of transfer values here to apply to individual members although there is nothing to prevent that power applying on a bulk basis. Both assets and liabilities can therefore be transferred under this power, but, when read in conjunction with the powers above, it does not seem to add anything that is not already covered.

4.9 Finally, Schedule 3 also contains a general provision (under paragraph 13) to allow the Secretary of State to make "such incidental, supplementary, consequential and transitional provisions as appear to the Secretary of State to be necessary or expedient". However, this would be restricted by the scope of the original powers under the 1972 Act . As established by similar wording in s.111 of the Local Government Act 1972 (which has been the subject of detailed judicial authority in a line of cases on vires issues), a public body can only exercise powers that are within the framework of being incidental etc to the original power and not for some completely different purpose.

Conclusion

4.10 From the analysis above, we believe that there is a clear statutory power to amalgamate funds (i.e. assets only). We do not believe there is such a clear power to transfer liabilities without looking at the way that those liabilities attach to AAs and/or scheme employers, as to which see below.

Future regime (post 2013 Act)

4.11 We now need to examine the different ways in which the 2013 Act and the 2013 Regulations deal with these powers.

4.12 Section 1 of the 2013 Act provides a power to make "scheme regulations" to establish schemes for payment of pensions and other benefits for local government workers.

4.13 It is interesting to note the use of the word "scheme" and the word "fund" in the 2013 Act, a complexity that is not present in the 1972 Act (which uses the word "fund" throughout).

"Scheme" is defined in the 2013 Act as meaning "*includes arrangements of any description*". In context, therefore, this would not necessarily be limited to new pension schemes (which would be "new public body pension schemes" covered by section 30). It is clear elsewhere that such an arrangement can be connected with another scheme (see section 4(6)). The term "scheme" is widely used in the 2013 Act. In general it can be taken as referring to the new benefit structures established under existing public sector pension arrangements.

It appears that the 2013 Act uses the word "fund" (although it is not defined) to refer to the assets supporting the "scheme".

4.14 From 31 March 2014 no further benefits can be provided under the existing regulations relating to the LGPS made under the 1972 Act except where the benefits can also be provided under the provisions of the 2013 Act (Section 18). However, to that extent, existing LGPS funds are treated as if they had been established under the 2013 Act (see Section 28(3)). In essence, Section 28 creates a bridging power to link pre 2014 and post 2014 LGPS benefits. However we note that section 28(2) preserves regulations made under section 7 of the 1972 Act:

"*to the extent that:*

(a) *such regulations make <u>provision for the payment of pensions and other benefits</u> [for post 1 April 2014 Service], <u>and</u>*

(b) *that provision could be made under scheme regulations."* [emphasis added].

4.15 This power is restricted in its scope to regulations which are for the purpose of "payment of pensions and other benefits", which would not encompass a power to amalgamate funds nor alter the Investment Regulations.

4.16 Section 3 provides for a broad power for regulations to be made by the Secretary of State(as the "responsible authority" under Schedule 2) in relation to schemes under the 2013 Act:

"3 Scheme regulations

(1) Scheme regulations may, subject to this Act, make such provision in relation to a scheme under section 1 as the responsible authority considers appropriate.

(2) That includes in particular-

(a) provision as to any of the matters specified in Schedule 3;

(b) consequential, supplementary, incidental or transitional provision in relation to the scheme or any provision of this Act.

(3) Scheme regulations may-

(a) make different provision for different purposes or cases (including different provision for different descriptions of persons);

(b) make retrospective provision (but see section 23);

(c) allow any person to exercise a discretion.

(4) The consequential provision referred to in subsection (2)(b) includes consequential provision amending any primary legislation passed before or in the same session as this Act (as well as consequential provision amending any secondary legislation).

(5) Scheme regulations require the consent of the Treasury before being made, unless one of the following exceptions applies.

(6) The exceptions are-

(a) scheme regulations of the Scottish Ministers relating to local government workers, fire and rescue workers and members of a police force;

(b) scheme regulations of the Welsh Ministers relating to fire and rescue workers."

4.17 On the face of it, this gives the Secretary of State very broad powers to legislate for anything connected to the LGPS, albeit subject to the 2013 Act. The general rules discussed in section 4.8 above about the reasonableness of the Secretary of State's decision-making powers would therefore also apply. The

Explanatory Notes to the Act give examples of what is meant by the limits prescribed by the phrase "subject to this Act", eg the scheme manager provisions in section 4.

4.18 Construing the rest of the language in Section 3 of Schedule 2 and the scope of the Secretary of State's powers is complex because of the following factors.

(a) The list of matters in Schedule 3, in Section 3(2)(a) which, as noted above, includes no reference to merger or amalgamation, is prefaced by the non-exhaustive words "in particular". The Explanatory Notes (para 20) reinforce this point: "If a matter is not mentioned in Schedule 3 this does not prevent it from forming part of such a scheme, provided it is within the powers given by sections 1(1) and 3(1)". (emphasis added albeit this is merely a note, not the statute itself) .

(b) The terminology in sub-Section 3(3) is also clearly very broad. The Explanatory Notes (para 22) are less helpful here: "This is a common provision in regulation-making powers to ensure that they are appropriately flexible." Of itself, however, the "purposes" or "cases" must still be referable to the scheme as envisaged by section 1.

(c) Finally, para 24 comments on the references to the "consequential provision" in Section 3(4): "only primary legislation passed before or in the same parliamentary session[10] as this Act can be amended. This power may be necessary where legislation is inconsistent with or requires modification as a consequence of scheme regulations or a provision of this Act. Section 24(1)(a) further requires that any amendment to primary legislation must be made by the affirmative procedure. The meaning of "affirmative procedure" is given in section 38(2)", which essentially says that any regulations have to be laid before both Houses of Parliament and approved by both Houses.

4.19 Taking all of these points together, there is a multiple test to establish whether "scheme regulations" can or cannot be made within the ambit of Section 3:

(a) they must be "appropriate" for the Secretary of State, acting reasonably, to make in relation to the LGPS;

(b) the list of matters in Schedule 3 is non-exhaustive and scheme regulations may be made for "different purposes or cases", but again must in some way attach to the LGPS as a scheme; and

(c) if a consequential provision is encapsulated within a regulation made under Section 3, it can only be passed by the affirmative resolution procedure, i.e. by both Houses of Parliament.

4.20 Applying these principles to the Act as drafted, the following conclusions can be reached. Section 3(2)(a) provides that regulations may be made in relation to the matters set out in Schedule 3. The provisions relevant to a transfer of benefits and the potential merger of funds are as follows.

(a) *"The payment or receipt of transfer values or other lump sum payments for the purpose of creating or restoring rights to benefits (under the scheme or otherwise)"* (paragraph 10 – emphasis added).

(b) *"Pension funds (for schemes that have them). This includes the administration, management and winding-up of any pension funds" (*paragraph 11 – emphasis added*).*

[10] **This is an annual period running from the first Thursday of May, the 2013 Act received Royal Assent on 25 April 2013 so the relevant session has now apparently passed.**

4.21 There is therefore no equivalent specific power under the 2013 Act allowing regulations to be made for the "amalgamation" of pension funds as under paragraph 2 of Schedule 3 of the 1972 Act. Notwithstanding this lack of a reference, we need to confirm whether the very broad power under Section 3 is sufficient to allow for amalgamation of funds, given the hurdles set out above. It is certainly odd that the wording was not carried over from the 1972 Act.

4.22 A contrary argument to the lack of an express reference to the power to amalgamate funds can be found in the wording of paragraph 11 to Schedule 3 of the 2013 Act. That paragraph, as quoted above, includes the words "*This includes*". Applying a general principle of construction, this would suggest that the activities which can be made the subject of regulations under Schedule 3 paragraph 11 is not exclusive and it might be argued that the amalgamation and merger of pension funds is necessarily to be implied in the phrase "*administration, management and winding-up*". We would recommend seeking Counsel's opinion on this argument.

4.23 We now need to consider whether the power to make regulations governing LGPS Funds themselves and the appointment of AAs could be used to transfer both the assets and the liabilities on an amalgamation (if that power could be exercised under regulations made under section 3(1)). Clearly, the assets of a particular LGPS Fund, on a merger or amalgamation, would then become assets of the new merged entity.

5 POWER TO SUBSTITUTE ADMINISTERING AUTHORITIES

5.1 The provisions relevant to the admission of "participants" (i.e. employers) into the LGPS are currently found in part 4 of the 2008 Regulations. There are two broad groups of participants (termed "employing authorities") whose employees may join the LGPS: Scheme Employers and Admission Bodies.

5.2 In each case the 2008 Regulations dictate the "appropriate fund" that the employees of each employing authority will be eligible to join (see below). The 2013 Regulations provide for a similar mechanism at Part 2 of Schedule 3.

5.3 Schedule 4, part 1 of the 2008 Regulations sets out a table of appropriate authorities. However, broadly:

(a) employees of an AA are members of the fund maintained by that authority;

(b) employees of an admission body are members of the AA's fund with which the admission body entered into an admission agreement; and

(c) where an authority does not have its own fund, the 2008 Regulations refer back to the Local Government Pension Scheme Regulations 1997 which, at Part 3 of Schedule 5, contains a list of authorities participating in other funds.

5.4 Schedule 2 of the 2013 Regulations contains the corresponding list of AAs to the 2008 Regulations. In order to sever the linkage between scheme employers and the appropriate AA that would necessarily happen on a merger, it would be necessary to amend these provisions to allocate an alternative fund to each scheme employer. Such an amendment could be made by "consequential" regulations under section 3(2)(b), which, as noted above, brings into play the affirmative procedure.

5.5 Schedule 4 of the 2008 Regulations further states that where an employing authority "merges or amalgamates" with another employing authority, or the members would be required to contribute to more than one fund, then the employing authority can make an application to the Secretary of State to direct to substitute the fund to which its employees are allocated. Note that it is the employing authority which must merge or amalgamate, not the fund itself, to trigger such a reorganisation.

Before making such a direction, the Secretary of State must consult with any affected bodies, but ultimately may:

"…require the making of financial adjustments between the funds, whether by way of payment to the substituted fund or a transfer of assets or both.

It may also contain provision as to the transfer of liabilities to the substituted fund, may require a revised rates and adjustment certificate in respect of each employing authority concerned, to take account of the effect of the direction and may make provision for any other consequential or incidental matters."

5.6 Consequently, since an "employing authority" is defined as "a body employing an employee who is eligible to be a member" any scheme employer or admitted body can make an application to the Secretary of State for a direction to substitute the fund in relation to its participation in the LGPS.

5.7 The power is dependent on each AA making an appropriate application and is not within the gift of the Secretary of State. Further, although these legislative provisions apply directly to substitute any fund applicable to a scheme employer or admission body, there is no specific provision for an automatic substitution of AA for the purposes of an admission agreement. Consequently, the admission body would have to enter into a new admission agreement with the new relevant AA on each substitution of fund.

5.8 Schedule 3 of the 2013 Regulations contain comparable but not precisely the same powers in relation to transfers. The relevant powers of the Secretary of State have been simplified in the language but again operate on application by the scheme employer, not as a reserved power:

"*3 The Secretary of State may, on application by a Scheme employer, by a written direction substitute a different administering authority as the appropriate administering authority for a person or class of person.*

4 A direction under paragraph 3-

(a) may only be given after the Secretary of State has consulted any bodies appearing to be affected by a proposed direction, and

(b) may include provision as to the making of adjustments between funds, the transfer of assets and liabilities, and any other consequential or incidental matters."

Note that, in order for these powers to be used, the Secretary of State must consult with the "bodies" affected by the proposed transfer.

Further on in Schedule 3, under paragraph 12, there is scope for regulations to be made in relation to:

"*The administration and management of the scheme, including –*

(a) the giving of guidance or directions by the responsible authority to the scheme manager (where those persons are different);

(b) the person by whom benefits under the scheme are to be provided;

(c) the provision or publication of the information about the Scheme." (Emphasis added)

From the above, it will be seen that paragraph 12(b) does allow the Secretary of State to make regulations in relation to changing an AA, given that that is the "*person by whom benefits...are to be provided*".

Transfer of statutory functions of current AAs to new bodies

5.9 In order to implement and administer a merger of funds successfully it would be necessary to transfer certain powers, including the administration and investment powers, from the current AAs to new AAs or to create one or more separate bodies to exercise those powers. In the past, this has always been done by primary legislation (see Section 7 below). No doubt that was because other non-pension powers were being transferred also.

It may be, if the conclusion is reached that the powers in Section 3 and Schedule 3 are broad enough, secondary legislation could be provided to achieve the same result.

5.10 Whichever route might be adopted, care would need to be taken if any transfers of funds and liabilities were to be made, in light of the South Tyneside[11] case.

5.11 In the South Tyneside case certain committees of five magistrates' courts were abolished and the liabilities transferred to a new body, after certain court reforms, the Lord Chancellor became successor to those liabilities. Despite the transfer, the Lord Chancellor refused to fund a deficit relating to former employees of the abolished magistrate's court committees. The Court of Appeal found that, on proper construction of the LGPS regulations then in force, there was no obligation on the Lord Chancellor to contribute to the fund in question as the employing authority's employees no longer made contributions to that fund.

5.12 This raises, in particular, the issue that making any transfers without clear legislative authority could have unintended consequences and that, on a transfer, contributions (including deficit payments) from "former" employers that are owed to the current AAs should be addressed before rather than after the event.

6 WHAT ARE THE POWERS TO TRANSFER ADMISSION AGREEMENTS AND/OR SUPPLY CONTRACTS?

6.1 One of the potential consequences of Option 3 would be the lack of a contractual relationship between the scheme employers and the relevant new AA that would assume responsibility for administering the merged fund. Existing contractual relationships are evidenced by an admission agreement. The terms of admission agreements are prescribed only as to their minimum content by regulations (Schedule 3 to the 2008 Regulations and Part 3 of Schedule 2 to the 2013 Regulations). These include certain automatic termination events, which are as follows:

(a) if the admission body ceases to be such a body (note that, under paragraph 8 of Schedule 3 of the 2008 Regulations, admission bodies must notify the AA of anything which may be a termination event. This includes a take-over, reconstruction or amalgamation of the employer, liquidation or receivership or a change in the nature of the body's business or constitution).

(b) on three months' notice (paragraph 9 to Schedule 3); and

(c) the parties to the admission agreement may also make such other provision about its termination as they consider appropriate.

[11] **South Tyneside Metropolitan Borough Council, R (on the application of) v The Lord Chancellor and Secretary of State for Justice & Anor EWCA Civ 299**

6.2 The requirements for the terms of an admission agreement do not envisage the possibility of merging funds or the novation/ assignment/transfer of the agreement where one party, the AA, simply disappears. It may be, of course, that individual agreements do cater for such events but in our experience, administering authorities do not draft their admission agreements to cater for anything other than the bare minimum requirements set out in statute.

6.3 Part 3 of Schedule 2 to the 2013 Regulations contains similar provisions at paragraph 9:

"*An admission agreement must include-*

(a) provision for it to terminate if the admission body ceases to be such a body;

(b) a requirement that the admission body notify the administering authority of any matter which may affect its participation in the Scheme;

(c) a requirement that the admission body notify the administering authority of any actual or proposed change in its status, including a take-over, reconstruction or amalgamation, insolvency, winding up, receivership or liquidation and a material change to the body's business or constitution;

(d) a right for the administering authority to terminate the agreement in the event of:

(i) the insolvency, winding up or liquidation of the admission body;

(ii) a material breach by the admission body of any of its obligations under the admission agreement or these Regulations which has not been remedied within a reasonable time;

(iii) a failure by the admission body to pay any sums due to the fund within a reasonable period after receipt of a notice from the administering authority requiring it to do so."

It will be noted that, again, there is no provision requiring automatic termination of admission agreements triggered by a merger of LGPS funds.

6.4 There are other provisions of admission agreements which would also need to be novated or assigned to the new AA on a merger under Option 3. These include the requirement for the admission body to pay contributions to the AA, which will be named specifically in the agreement and so will be the "wrong" party.

6.5 Any changes to admission agreements and, more widely, any supply contracts, will need to be made individually to each agreement under its specific amendment terms or by way of overriding legislation. Without an overriding statutory power, such as that used on the reorganisation of Welsh local government in 1995, this would be a very significant undertaking.

7 EXAMPLES OF TRANSFER OF OBLIGATIONS AND LIABILITIES OF ADMINISTERING AUTHORITIES

7.1 In this section we briefly examine three precedents for reorganisations of LGPS funds, which each followed on from wider local government changes. In two cases (the GLC and Welsh authorities) primary legislation was used. We have not considered in detail whether it would have been possible to avoid the use of primary legislation, but given the wider ambit of each reform the question may be academic.

7.2 Abolition of the Greater London Council (GLC).

(a) The Local Government Act 1985 (LGA 1985) provided for the abolition of both the GLC and the Metropolitan County Councils, with effect from 1 April 1986. A number of the functions of the GLC were transferred to the London Residuary Body set up for that purpose.

(b) Section 60 of the LGA 1985 provided for the automatic transfer of the GLC's position as an AA to the London Residuary Body. This included, specifically:

(i) functions as an AA under Regulations made under Section 7 of the 1972 Act; and

(ii) all liabilities of the GLC in respect of pensions payable by it or otherwise.

(c) These functions and liabilities were then transferred to the LPFA on the winding up of the London Residuary Body at the end of October 1989.

(d) Since the GLC had a number of statutory functions other than acting as an AA, and Government was also abolishing other Metropolitan County Councils, it is not unexpected to find that Government chose to use primary legislation Act to transfer the AA functions of the GLC.

7.3 Local Government Reorganisation in Wales

(a) The Local Government (Wales) Act 1994 (the 1994 Act) contains, at Section 17, a general provision to transfer the functions of the councils being abolished. It has the effect of amending all legislation that referred to the previous council so that it instead refers to the new principal area (post re-organisation).

(b) The Act does not, however, deal with the specifics of the transfer of LGPS functions. This was enacted by the Local Government Pension Scheme (Local Government Reorganisation in Wales) Regulations 1995, which were made under section 7 of the 1972 Act (and not under the 1994 Act).

(c) These Regulations provide for the wholesale transfer of each previous council's functions and obligations as an AA to the successor authority.

(i) Transfer of functions as AA, along with rights and liabilities:

"*all the functions of a previous fund authority as AA under the principal Regulations then in force shall become functions of the successor authority and the pension fund maintained by the previous fund authority, together with all rights and liabilities in respect of it, shall on that date vest in the successor authority*."

(ii) Employing authorities and admission bodies' obligations to contribute to that fund are moved:

"*any liability of any body or person to make payments into a pension fund maintained immediately before 1st April 1996 by a previous fund authority shall become a liability to make payments into the pension fund maintained by the successor authority*"

(iii) Contracts in place for the purposes of the pension fund were novated:

"*All contracts, deeds, bonds, agreements and other instruments subsisting in favour of, or against, and all notices in force which were given by or to a previous fund authority (or any other body on their behalf) for the purposes of the pension fund maintained by them shall after 31st March 1996 be of force [sic] in favour of, or against, the successor authority*"

(iv) Admission agreements:

"*Without prejudice to the generality of paragraph (3), any admission agreement in force immediately before 1st April 1996 between a body and a previous fund authority whereby employees of that body were, or could be, admitted to participate in the benefits of a pension fund shall after 31st March 1996, have effect as an agreement under regulation B7 of the principal Regulations between the body and the successor authority*".

(v) The obligation to contribute in respect of previous employees was also moved to the successor authority:

"*Where a person-*

(a) has ceased to contribute to a pension fund before 1st April 1996; and

(b) has not become a contributor to any other fund maintained under the principal Regulations

the pension fund maintained by the successor authority for the previous fund authority who maintained that fund until 31st March 1996 shall after that date be deemed to be the fund to which he was last a contributor."

7.4 South Yorkshire Pensions Authority

The Residuary Body

(a) The Local Government Reorganisation (Pensions etc) (South Yorkshire) Order 1987 (the "SY Order") was made under powers in section 67(1)(a) of the LGA 1985:

"*The Secretary of State may by order provide for any such transfer or disposal as is mentioned in subsection (1) or (2) above, whether as proposed by the residuary body or otherwise, and for giving effect (with or without modifications) to any scheme submitted to him under subsection (1) above; and, without prejudice to the generality of that power, any such order may contain such supplementary and transitional provisions as the Secretary of State thinks necessary or expedient, including provisions amending any enactment or any instrument made under any enactment or establishing new bodies corporate to receive any functions, property, rights or liabilities transferred by the order*."

(b) The above power is a general one for the Secretary of State to make orders to implement an arrangement for the wind up of residuary bodies, and transfer of powers to the new authority (this arrangement is referred to in the power as a "*transfer or disposal as is mentioned in subsection (1) or (2) above"*). The residuary body in question was created by the LGA 1985 as a result of the abolition of the Metropolitan County Councils ("MCCs").

(c) These powers are clearly specific to the circumstances provided for by the LGA 1985 (i.e. the abolition of the GLC and the MCCs), which depend on there being a "residuary body" and the

removal or abolition of the powers of that body. However, it provides a precedent for a broad provision in primary legislation to be used to transfer pensions rights and obligations.

(d) As an aside, the Residuary Body was not given fund raising powers in its own right; it was granted the power by Section 74 of the LGA 1985 to make levies on the rating authorities in its areas to "*meet all liabilities falling to be discharged by it*".

<u>Transfer of pension functions</u>

(e) The SY Order established the South Yorkshire Pension Authority as a body corporate specifically to receive "*functions, property, rights and liabilities transferred by this Order*". The SY Order then went on to make the transfer of all the obligations and liabilities of the residual body in relation to pensions (as specified in Schedule 2):

"(a) the functions of the Residuary Body as [AA] under the Local Government Superannuation Regulations 1986, together with the superannuation fund maintained by the Residuary Body and all property, rights and liabilities in respect of it;

(b) the functions, rights and liabilities of the Residuary Body in respect of pensions payable by it otherwise than under those Regulations;

(c) without prejudice to the foregoing, the functions, rights and liabilities which are vested in or fall to be discharged by the Residuary Body under or by virtue of section 61 of the 1985 Act (payment of pensions increases); and

(d) any moneys or other property forming a fund maintained by the Residuary Body for the purposes of the functions referred to in sub-paragraphs (b) or (c)."

(f) The SY Order also made provision for the funding of the South Yorkshire Pension Authority. Article 4 provides:

"*The net expenditure of the Authority in any financial year shall be apportioned between the district councils in the county of South Yorkshire in proportion to the population of their districts, as that population is certified for the making of levies with respect to that year under section 74(2) of the 1985 Act (levies by residuary bodies); and the appropriate portions shall be recoverable by the Authority from each of those councils on written demand*."

8 HOW WOULD THE PROPOSAL AFFECT PUBLIC SCHEMES OTHER THAN THE LGPS?

8.1 The proposal to include non-LGPS schemes in any of the three Options under consideration raises completely different and, in our opinion, insuperable problems which cannot be addressed simply by legislative means (whether primary or secondary). The problems relate to the fact that the trustees of each of the schemes under consideration are bound by the powers that are given to them under their respective trust instruments and also by private sector pensions legislation which reserves to those trustees the following key powers, which can only be exercised unilaterally:

(a) the power of investment ; and

(b) the power to transfer assets to another registered pension scheme.

We have not considered any of the trust deeds and rules of the schemes listed in the schedule provided by DCLG and therefore the following analysis draws on general points of principle.

Investment Powers

8.2 In relation to the power of investment, section 34(1) of the Pensions Act 1995, which applies to all occupational pension schemes set up under trust, provides that the trustees of such a scheme shall have the powers of an absolute and beneficial owner. Section 34 provides that trustees may delegate decisions about investments and, in fact, they are required to delegate all day to day decisions to an authorised fund manager if they are not authorised under the Financial Services and Markets Act 2000 for the purposes of investment management activity themselves. This points to the fundamental difference between trustees and AAs in the LGPS context, because trustees are deemed to be acting on behalf of other persons (ie the members and, on some analysis, the scheme employer) in managing the investments subject to their trust. AAs, on the other hand, although absolutely entitled to the assets held within their funds, are acting as principals and not engaged in the activity of managing investments for another person.

8.3 Section 35(4) contains an express reference to the freedom of trustees that is encapsulated in section 34, as follows: "neither the trust scheme nor the statement [of investment principles] may impose restrictions (however expressed) on any power to make investments by reference to the consent of the employer."

8.4 In further support of the principle that trustees' powers of investment must be unfettered, there is a body of case law which comments on attempts to restrict or manipulate trustees' investments powers where they are not exercised for the best interests of the beneficiaries of their scheme.

8.5 In conclusion, although it would be possible, subject to the constitutional framework under which a common investment vehicle was established under options 1 and 2, for the trustees of occupational pension schemes to participate in such a vehicle, there is no mechanism by which trustees could be forced to do so. The fact that the trustees of the schemes under question are responsible for discharging liabilities that may in the past have stemmed from public sector schemes does not alter this analysis.

Merger

8.6 There are similar considerations relating to the power to merge schemes to those which apply to the powers of investment discussed above. Although there is no statutory framework for limiting or circumscribing the powers of trustees to transfer out assets and liabilities (or to receive them when a merger takes place), the trust deed and rules will contain the relevant powers which have to be relied upon by the trustees of both the receiving and the transferring schemes. Again, there is a considerable body of case law describing how those powers ought to be exercised, but in brief they must be exercised, as with other fiduciary powers, in the best interests of the members of the relevant scheme and not for some ulterior purpose. It is possible under private sector legislation (The Occupational Pension Schemes (Preservation of Benefits) Regulations 1991) for members' benefits to be transferred without their consent, subject to both giving the members one month's notice of a proposed transfer and obtaining a certificate from the transferring scheme actuary that the benefits to be provided by the receiving scheme are "broadly no less favourable" than those to be transferred.

8.7 Funding considerations are also obviously key, as is a consideration of the potential differences in the balance of powers between the trustees and the sponsoring employer of the receiving vehicle.

8.8 In summary, the ability of trustees of private sector schemes, again without limitation as to their origin and linkage to public sector benefit structures, is governed by the trust deed and rules of the relevant schemes and there is no overriding statutory basis on which such schemes could be forced to transfer their assets and liabilities into another receiving scheme.

Department for
Communities and
Local Government

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

Government response to the call for evidence

May 2014
Department for Communities and Local Government

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1. Government response to the call for evidence

1.1 This paper sets out the Government's response to the call for evidence on the future structure of the Local Government Pension Scheme which ran from 21 June to 27 September 2013. It provides a high level summary of the key themes raised under each question and attempts to capture the wide range of sometimes contradictory views expressed by respondents. It also outlines the fund specific data, wider evidence and opinion cited by respondents in support of their arguments. In addition to this paper, the Government has responded to the call for evidence by publishing a consultation on principles for reform, which provides fuller details of the Government's proposals. You can access this consultation at https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies.

Background to the call for evidence

1.2 In 2010, the Government commissioned Lord Hutton to chair the Independent Public Service Pensions Commission to review public service pensions and make recommendations on how they might be made more sustainable and affordable in the long term, while being fair to both taxpayers and public sector workers. Lord Hutton's final report was published on 10 March 2011. In the report he highlighted the collaborative approach being taken by funds within the Local Government Pension Scheme and recommended that the benefits of co-operative working be investigated further.

1.3 Recognising the scope for potential savings to the Scheme, the Department hosted a round-table event to consider these issues with the Local Government Association in May 2013. The objectives for reform identified at the round-table fed into the call for evidence on the future structure of the Scheme which ran over the summer. This asked respondents to consider how the administration, structure and management of the Scheme might be reformed to reduce fund deficits and improve investment returns, as well as cut investment fees and administration costs, strengthen the availability and quality of in-house resource, and improve the flexibility of investments. The responses were shared with the Shadow Scheme Advisory Board, which provided the Minister for Local Government with its recommendations and analysis of the responses. A copy of this analysis is available from the Shadow Board's website at http://www.lgpsboard.org/index.php/structure-reform/board-analysis-menu.

1.4 In addition to the responses to the call for evidence, the Government's consultation has been informed by both the recommendations of the Shadow Board, and further analysis commissioned by the Minister for Local Government and the Minister for the Cabinet Office using the Contestable Policy Fund. This detailed analysis was undertaken by Hymans Robertson who was asked to examine three proposals: creating 5-10 merged funds, establishing 5-10 common investment vehicles or setting up one common investment vehicle. The analysis, which identified scope for savings of up to £660 million each year, set out the costs and benefits of each option;

the time required to realise savings; and the practical and legal barriers to implementation. A copy of the Hymans Robertson report is available at https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies.

2. Summary of responses and proposals

2.1 133 responses to the call for evidence were received in total, over half of which were from local authorities with scheme manager responsibilities; 69 of the 89 funds in England and Wales submitted a response. 35 responses were from firms working in the pensions industry, four from trade unions and Scheme members, and 12 from other representative bodies. The majority of respondents recognised the benefit of some change, although there was less of a consensus about the type of change needed.

Q1. How can the Local Government Pension Scheme best achieve a high level of accountability to local taxpayers and other interested parties – including through the availability of transparent and comparable data on costs and income – while adapting to become more efficient and to promote stronger investment performance?

2.2 The responses to this question focused on two key themes about how best to achieve a high level of accountability, transparency and governance across the Scheme: maintaining the link to democratically elected councillors, and improving the transparency of data.

Maintaining the link to local councillors

2.3 The Shadow Board's analysis indicates that 70 respondents, 53 of which were fund authorities, highlighted their concern over the loss of local accountability. It argued that there was a strong role for democratically elected members in taking decisions on the investment strategy, investment management and administrative matters, based on advice from officers, actuaries and independent advisors. The ability to set a tailored investment strategy and determine the asset allocation locally was seen as especially important amongst respondents from both the public and private sectors. Respondents argued that the link to elected councillors is necessary to hold the funds to account, as the deficit in any fund will ultimately fall to local taxpayers. Indeed, an increase in deficit will lead to higher contribution rates that may be funded either through an increase council tax or reduced services.

2.4 Some respondents also suggested that it would be unfair to merge funds because each fund has developed its own historic deficit or funding level that should be addressed locally. They argued that merging funds could impose a reduced funding position on better funded schemes.

2.5 Finally it was seen as crucial by some respondents that funds should be accountable to both employers and members. In particular, they suggested that as employers have individual contribution rates, they need assurance that their assets are ring-fenced from inappropriate intervention. These submissions argued that as the number of Scheme employers continues to grow, their representation is more easily delivered at the local level through adequate employer representation on investment

committees. In the same vein, many were concerned that merging funds would reduce accountability as governance would no longer sit in the communities in which the fund operates.

2.6 However, a smaller number of respondents suggested that maintaining the link to local councillors did not add to fund accountability and questioned whether this needed to be maintained. Since pensions are not commonly featured on the agenda of most local elections, some felt we should question the extent to which the funds are truly accountable to local taxpayers, especially where the fund covers several authorities. Others suggested that funds could make greater use of professional specialists in directing scheme governance to reduce the impact of political interests on investment decisions.

The Government recognises that local determination of a fund's asset allocation was seen as a vital consideration amongst respondents to the call for evidence. A common investment vehicle could be designed to allow asset allocation to remain at local fund authority level, consistent with ensuring that decisions are taken in line with existing local accountabilities.

Data needs to be more comparable. This will improve transparency

2.7 Many respondents, and fund authorities in particular, drew attention to the volume of reports and data produced about the Scheme. This includes the compulsory, audited accounting reports and the optional benchmarking activity undertaken by most funds with the Chartered Institute of Public Finance and Accountancy and the WM Company. However, whilst they recognised that data is available, many respondents also argued that the current quality of data could be improved. Indeed, one respondent highlighted a case where a fund appeared to report the same item differently in two separate data sources.

2.8 Whilst split on the effectiveness of the current reporting arrangements, the majority of respondents agreed that the data provided needs to be comparable in order to improve decision making, accountability and transparency. Further discussion about the types of data required and how best to collate and analyse it is provided under question five.

Q2. Are the high level objectives listed those we should be focusing on and why? If not, what objectives should be the focus of reform and why? How should success against these be measured?

Are they the right objectives?

2.9 The call for evidence cited two primary objectives; dealing with deficits and improving investment returns. Although very few responses rejected the objectives outright, many felt that they could be improved or clarified.

2.10 In particular, many respondents argued that both objectives should be considered in

the context of investment risk and sustainability. Several indicated that care was needed when pursuing “improved investment returns” or “reduced deficits” as they could be achieved using methods detrimental to the funds in the long term. For example, deficits could be reduced through higher contribution rates, but this may make the fund unsustainable for employers in the long term. In addition, two responses emphasised that investment returns can only be improved without taking excessive and potentially inappropriate risk, if performance to date has been sub-optimal. As such, several organisations suggested that the objective be rephrased to focus on “managing deficits” through realistic deficit recovery plans, rather than “dealing” with them, in part to discourage excessive risk and volatility in improving investment returns.

2.11 Whilst the majority of respondents agreed that deficit reduction is important for the funds, several commented that it was unlikely to be delivered through structural reform. Responses from both the public and private sector also argued that deficit reduction was already a priority for funds, with some seeing it as more of a means of ensuring the long term stability and durability of the Scheme.

What should be the primary objectives?

2.12 Whilst the exact phrasing around what the primary objectives should be differed across the responses, the following themes were prevalent:

- Ensuring the long term sustainability of the Scheme, including stable membership.
- Developing strong governance arrangements and better decision making for all funds.
- Achieving a fully funded scheme and lowering the burden on council tax payers.
- Delivering stable contribution rates for employers and employees.
- Being able to pay pensions and benefits as they fall due.
- Improving risk adjusted returns.
- Achieving value for money, with a focus on quality as well as cost.

The Government believes that all of these objectives listed, including reducing fund deficits and improving investment returns, can be seen as facets of the first bullet point: ensuring the Scheme is sustainable in the long term. For example, the Scheme will be more sustainable if it is affordable – achieving a fully funded scheme will help to reduce and stabilise the cost to employers, employees and council tax payers, as well as ensuring that benefits can be paid on time. Improving risk adjusted returns and securing value for money in the Scheme administration and management will help the Scheme move closer to being fully funded. Higher returns and better value for money are more likely to be realised if funds have strong governance and decision making arrangements in place.

The Government has therefore focused on this overarching objective, of long term sustainability, in developing its consultation and proposals for Scheme reform.

How should success be measured?

2.13 The majority of responses focused on how the funds might be evaluated and their

individual performance measured, rather than how the success of any structural reform programme might be analysed.

2.14 Both private and public sector responses suggested a range of measures of fund performance. These included:

- How the funding level or investment performance improves compared with the actuary's forecast or the fund's long term deficit reduction plan (that is, evidence the deficit is reducing over time);
- Credibility of deficit reduction plans;
- Affordability of contribution rates;
- Reduced calls on council tax; and
- Strength of cash flow.

2.15 Other less popular suggestions were focused on administration costs, such as comparing unit costs per member. A few focused on governance and stability, for example using a measure of reduced manager turnover to assess performance.

2.16 Although the measure suggested differed, most respondents focused on a mechanism for assessing a fund's deficit. One organisation went further than most, suggesting that the funds could follow the private sector model, where annual recovery plans are submitted to the Pensions Regulator and those forecasting recovery over more than 10 years subject are to additional scrutiny.

2.17 Around 10 public and private sector organisations referenced the impact that changes in the gilt market can have on deficits. Some argued that market volatility over time should be considered, rather than a funding level judged on one day every three years.

Q3. What options for reform would best meet the high level objectives and why?

2.18 As the Shadow Board identifies in its review of the call for evidence, very few responses discussed how to manage fund deficits. The Shadow Board went on to recommend that it support the Government by developing a shortlist of feasible options for managing deficits and conducting further research into the costs and benefits of the key options for reform.

> The Government agrees that opportunities to improve funding levels should continue to be explored and looks forward to considering the Shadow Board's proposals for alternative ways of managing deficits. The consultation also welcomes views on how deficits might be managed.

2.19 The majority of both public and private sector respondents instead focused on how to address the secondary objectives; particularly reducing investment and administration costs through more efficient management.

2.20 Several respondents argued that a range of options for reform should be available to funds, since each has their own funding position, cash flow and membership profile. Many felt that any Government proposal should be adopted on a voluntary basis;

with others suggesting that the Government should offer further support to existing examples of collaboration and other initiatives looking to improve efficiency and performance. Some argued that only those unable to demonstrate improvement or who consistently perform poorly should face compulsory mergers or collective investment vehicles, whereas others recognised the need for wider participation in order for any proposal to generate significant savings.

Is bigger better?

2.21 Many respondents elected to address this section by discussing the advantages and disadvantages of mergers and common investment vehicles; with the latter proving considerably more popular. Additionally, many respondents highlighted the importance of collaboration, procurement frameworks and strong governance in meeting the objectives. However, a key issue discussed by most respondents was the extent to which size delivered benefits for the funds.

2.22 There was a lot of contradictory data and opinion expressed in the call for evidence about the correlation between fund size and performance. A mixture of fund specific evidence, international evidence and academic papers were referenced by respondents when engaging with this topic. A list of the most commonly cited academic papers is available on the Shadow Board's website http://www.lgpsboard.org/index.php/structure-reform/responses-public-view#Annex3.

2.23 A small number of submissions, predominantly from private sector organisations, argued that bigger funds performed better, pointing to the following research and evidence:

- A paper from the Rotman Institute showing larger international funds outperforming smaller ones by 0.43-0.50 per cent per year.
- Evidence that Scheme funds which are greater than £10 billion generate higher returns and experience less volatility than smaller schemes.

2.24 In contrast, several respondents cite evidence to show that there is no correlation between fund size and performance. One organisation included a chart showing the annual investment returns achieved across all Scheme funds by fund size over the last two decades, which indicated that performance does not appear to be affected by fund size; with some smaller funds out-performing larger funds.

2.25 On balance, the evidence available suggests that there is no conclusive link between investment returns and fund size, but that there may be other advantages of scale. Several respondents provided evidence of larger funds harnessing lower investment and administration costs. Indeed, one private sector organisation looked at 12 Scheme funds of around £8 billion and found investment and administration costs as a percentage of asset value decreased with size. This view was also shared by the Shadow Board following their analysis of the call for evidence, who argued that:

> The evidence appears to show indirect benefits of larger fund sizes, although any direct link between fund size and investment return in the Local Government Pension Scheme is inconclusive.

2.26 A number of the responses and reports highlighted significant benefits to scale such as increased use of internal management, greater diversification of asset classes and managers, and a more responsive governance structure. As such, a number of submissions argued that where evidence has suggested larger funds perform better; this may be largely attributed to these other characteristics commonly found in larger funds; and which smaller funds or common investment vehicles may also harness.

How to achieve scale?

2.27 Having set out the case that there are significant benefits attributable to scale, particularly in terms of cost reduction, respondents discussed the relative merits of mergers and common investment vehicles as mechanisms for attaining this scale.

2.28 The following arguments were raised in favour of mergers being the best option for reform, although the case was made by only a few respondents overall:

- Larger funds brought about by mergers are better able to reallocate resources to attract the right investment professionals and pay them sufficiently; building up their in-house resource and enabling them to secure lower costs.
- Others stated larger funds will deliver economies of scale in investment and administration costs. They argued that increased scale generates collective bargaining power to negotiate lower fees with fund managers, especially in the more expensive alternative asset classes.
- Some respondents who were not generally in favour of mergers still argued that they could be pursued either between small funds located close to each other, or in cases where clear governance or financial maladministration is shown to have occurred.

2.29 However, mergers were more commonly mentioned in the context of their drawbacks by respondents from all sectors. Key arguments against mergers included:

- Mergers are likely to have very high transition costs with further cost benefit analysis needed to understand exactly how much.
- Mergers will require substantial resources and time to implement effectively.
- There are potential risks to the Scheme and market of concentrating the fund too heavily and moving such large amounts of assets.
- Many underlined the difficulty of cross subsidising weaker funds and how to merge them with better performing ones.
- Roughly 15 respondents noted that merging funds would not tackle deficits.
- 23 respondents, mainly from the private sector, raised the issue of constrained capacity if funds were merged. Two investment firms cited examples of their own policy of closing investment strategies before they get too large to manage effectively.

2.30 Instead, many across the sector argued that the benefits of a merger might be achieved more quickly, simply and economically through common investment vehicles. Around 75 of the 133 respondents supported common investment vehicles or the ‘pooling of assets’ as an option for reform. Further benefits in relation to the secondary objectives are discussed under question four. Key arguments included:

- Common investment vehicles should deliver most of the cost reduction benefits of mergers but they can be realised more quickly; not least because setting up the vehicles does not require primary legislation.
- Common investment vehicles can harness economies of scale in the same way as mergers, for example through increased bargaining power on fees.
- This approach would allow authorities to maintain the direct link to accountable, elected councillors, seen as fundamental by most respondents.
- Others noted how this option still allows for different deficit positions and recovery periods; so that each fund can take into account the profile of their liabilities when determining their funding strategy.

> Having considered these points and Hymans Robertson's cost benefit analysis, the Government has decided not to consult on fund mergers at this time. Nevertheless, there remains a strong case for achieving economies of scale and other benefits through the use of common investment vehicles, and the Government plans to consult on this basis.

Governance

2.31 Although discussions around reducing deficits were limited, many fund authorities suggested that improving governance arrangements would have a significant benefit.

2.32 A few used this to argue that structural reform was unnecessary as they saw good governance as the key to both tackling deficits and improving investment returns.

2.33 Some respondents proposed that the best means of improving governance centred around greater scrutiny of the funds, with suggestions of how to do this ranging from a light touch regulatory regime based on standard codes of practice and guidance, to setting up regional scrutiny boards akin to Ofsted for schools to share expertise and avoid unnecessary duplication. Others felt that the governance proposals set out in the 2013 Act already serve as a strong model, by introducing local boards and a national scheme advisory board which can take a long term strategic focus and encourage the sharing of best practise.

2.34 Conversely, some submissions argued that existing and proposed governance arrangements do not go far enough, as the whole system needs to be professionalised. One private sector organisation suggested setting up a permanent, professional investment committee to manage investments, with elected officials still setting the long term strategy. Others pointed out that larger schemes (through common investment vehicles or mergers) can access better governance; drawing on international evidence that suggests the success of pension funds in Canada and the Netherlands is largely down to their size which has freed up resource to invest in a robust and dedicated governance structure.

> Following the responses to the informal governance discussion paper which was published in June 2013, and as required under the 2013 Act, the Government plans to consult separately on governance with draft regulations later in the spring.

Procurement frameworks and collaboration

2.35 The use of procurement frameworks and collaboration more generally was cited by around 85 of the 135 respondents as a positive option for reform. Most respondents sought to highlight the benefits they have experienced of using frameworks, with some promoting this as a stand alone option, regardless of any other reforms which may be taken up. It was generally felt that the Government should lend its support to collaboration initiatives already underway. More discussion on this option can be found under question four in relation to achieving the secondary objectives.

Q4. To what extent would the options you have proposed under question 3 meet any or all of the secondary objectives? Are there any other secondary objectives that should be included and why?

Are these the right objectives?

To reduce investment fees

2.36 A number of respondents suggested that the inherent focus on gross fees was not helpful in this objective. They suggested that it took little account of the differences between active and passive management, arguing that higher fees may be justified if growth can be linked directly to manager performance. A number of ideas were proposed to deal with this:

- Name of objective should be changed to 'improving value for money'
- Fees should be explored against risk adjusted returns

2.37 Some respondents also argued that the potential for savings under this objective are limited since Scheme fees are already broadly comparable with the global benchmark; particularly on core mandates such as passive products, bonds and equities. One organisation mentioned that whilst most managers offer a tiered fee structure which reduces as assets grow, the majority of this benefit is achieved once assets reach around £500 million, and hence there would be little merit from a cost reduction perspective of pooling assets beyond this level.

2.38 However, a few respondents noted that more complex arrangements such as "fund of fund structures" drive higher fees. Since a number of funds use these structures to invest in alternative asset classes, it was suggested that the scope for savings may be more significant here.

2.39 In addition, a number of respondents cited analysis by Hymans Robertson published shortly before the call for evidence closed which showed that fees were broadly comparable with the global benchmark, particularly on listed assets such as bonds and equities. Some respondents went on to suggest that passive management may help to reduce investment fees, rather than structural reform. They discussed the potential cost savings and decreased risk that could be achieved by greater use of passive management across the Scheme, questioning whether active management is appropriate for traditional asset classes and whether the returns justify the fees.

Two local authorities referred to evidence of significant fee reductions resulting from their use of passive management, although others were keen to demonstrate their use of active management to achieve good rates of return over longer periods, and presented some fund specific examples of this.

The Government believes it is possible to significantly reduce investment fees and other costs of investment by using passive management for listed assets, since the aggregate fund performance has been shown to replicate the market. The Government therefore plans to consult on this option, and on maintaining the use of active management for alternative asset classes through a common investment vehicle. Please refer to the consultation document for full details.

To improve the flexibility of investment strategies

2.40 Many submissions argued that the investment regulations are currently too restrictive, hampering the return opportunities and risk management of Scheme funds and prohibiting appropriate investment strategies. Specifically, they place restrictions on the amount of a fund that can be invested in certain types of vehicle, for example limited partnerships in aggregate are subject to a limit of 30 per cent. The issue of rigidity in the investment regulations was underlined in around 16 submissions.

2.41 Respondents suggested various ways to improve investment flexibility; with the most popular being to reform the investment management regulations. Some submissions also suggested that the greater size of a pooled or merged fund may enable recruitment of better quality investment professionals who could form an investment committee; streamlining decision making and improving access to complex hedging strategies and risk management tools. Others felt flexibility could be improved through the use of frameworks with pre approved managers to reduce the time lost between investment decisions being made and subsequent implementation.

The Government recognises that the investment regulations are in need of review. The Department will consult separately on reforms to these regulations, which will be developed in light of the consultation on structural reform.

To improve the cost effectiveness of administration

2.42 Amongst those who commented on administration reform, which was generally taken to mean aggregating administration services, many were quick to point out how any savings will be marginal in comparison with investment costs. Several responses suggested the scope for savings was limited, for example because administration costs were already low, or because authorities already used the same IT system. Respondents also argued that since costs were driven by the number of members and employers, savings would be minimal as this would not change under a merged administration. In addition, many were keen to highlight the potential loss of local links with employers and local accountability; making it harder for example, to hold local surgeries with employers and deliver face to face support for scheme members. Similarly they noted the risks of reforming administration, increasing the risk of incorrect payments and associated difficulties; especially in light of the new 2014 Scheme being introduced in April generating increased complexity.

2.43 In contrast, some respondents suggested that savings could be found. They argued that larger funds are able to achieve lower administration costs, citing a mixture of personal evidence and tables derived from the Department's statistical data set relating to the Scheme (SF3 data) to demonstrate this. For example, one shared service venture set out that it had saved £500,000 per annum by reducing staff and accommodation costs, ending outsourcing, using greater automation, introducing consistent processes, and creating a single database, with member and employer self service. Another fund analysed a sample of admin costs from 100 Scheme funds over three years to show that larger funds have administration costs that are on average, £5-£25 per member lower than smaller funds each year.

The call for evidence has highlighted the scope for potential administrative efficiencies as well as the associated risks. At this stage, the Government proposes to allow the administration arrangements for the 2014 Scheme to mature before considering reform any further.

To provide more in-house investment resource/access to higher quality staffing

2.44 A number of submissions stressed the potential benefits of in-house management and access to higher quality staffing, citing a mixture of their personal experiences and international evidence to support their argument. For example, 28 responses referenced State Street analysis which concluded that in-house management was more cost effective for larger funds and may lead to better investment performance outcomes, whilst Canadian public sector pension funds were used as a peer comparison in six responses as evidence of successful in-house management due to the size of the funds. Some pension fund authorities and one professional body also included data demonstrating that the Scheme's internally managed funds outperformed those externally managed by 80 basis points per annum over the 10 years to 31 March 2012 (50 basis points over 20 years).

2.45 Nevertheless, several submissions also pointed out the risks of in-house management, including the difficulty arising from restrictive local authority pay scales that may not allow for these specialist roles to be filled by sufficiently experienced staff. Following on from this, one fund authority underlined how external providers offer specialist skill and research capabilities, particularly for active management and alternative assets, which are very difficult for in-house providers to match. Another fund also noted that for passive management the economies of scale achieved by the major external providers and the technical skill required to track benchmark indices makes in-house management impractical.

To enhance investment in infrastructure

2.46 Many respondents took issue with the focus on enhancing investment in infrastructure as an objective for reform, with some suggesting it could enable local politicians to invest in local infrastructure projects which may not serve the long-term interests of the Scheme. It was argued that investments should only be made following an appropriate assessment of anticipated returns relative to risk levels, and that the objectives should not encourage investment in one particular asset class. 47 of the 133 submissions espoused this view.

2.47 A minority of respondents in favour of increased investment in infrastructure highlighted how a super pool would achieve the scale to enable funds to directly access alternative assets such as infrastructure, without the high fees associated with “fund of fund” arrangements. Conversely, some did not see fund size as a restriction to infrastructure investment. One fund authority cited their own experience of having agreed and implemented two infrastructure investments with two unlisted infrastructure managers, despite being small.

How would the following models deliver these objectives?

Shared Services/Frameworks

2.48 A number of joint procurement framework initiatives are currently underway. It was broadly felt that frameworks saved time and money when procuring specialist pension fund services; leveraging the combined buying power of the Scheme whilst still meeting local requirements and accountability. The use of frameworks specifically was mentioned by around 34 respondents, 25 of which were local authorities; although the benefits of more general ‘collaboration’ were also discussed in most responses.

2.49 The most frequently mentioned benefit of frameworks in relation to achieving the secondary objectives was significantly reducing the cost of administering funds and procuring services. The National LGPS Frameworks presented evidence of one fund that paid £4,000 to procure an actuary through their framework compared to an estimated £30,000 to £40,000 for a full procurement process. Moreover, the National LGPS Frameworks claim that procurement timescales have been reduced from 6-12 months to 4-8 weeks as the frameworks are already compliant with EU regulations and contain pre-agreed terms and conditions. In addition, respondents suggested that sharing resources under collaborative working or joint procurement may facilitate the retention of existing high quality staffing resources.

> Although there are clear benefits to using frameworks, the scale of savings achievable through them does not match those possible through more substantial reform such as the use of common investment vehicles. However, the Government believes that there is an important role for procurement frameworks to play in delivering savings for the Scheme and is keen to see this opportunity taken up by more of the funds.

Common investment vehicles

2.50 A majority of respondents commenting on this question were keen to detail the ways in which asset pooling through common investment vehicles would meet all or most of the secondary objectives: Key points raised include:

- Investment fees should be lowered by economies of scale through co-investing, and this will be more noticeable in the more expensive alternative asset classes such as infrastructure and private equity.
- Funds could still retain the flexibility to hire their own managers where they felt this might produce superior returns.
- Increased collaboration through the common investment vehicle may serve as a platform for future collaboration or mergers in administration services.

- If the vehicle is managed by a lead local authority or a local authority shared service, then collaboration through it should improve resilience and access to higher quality staff, as the host authority would employ staff with appropriate expertise who can then offer services to other funds. Eventually this could lead to a build up of in-house management expertise; although this was not always felt to be appropriate as an objective.

Q5. What data is required in order to better assess the current position of the Scheme, the individual Scheme fund authorities and the options proposed under this call for evidence? How could such data be best produced, collated and analysed?

2.51 As discussed under question one, there was a general consensus that the current data is not designed to guide strategic decision making, with 94 of the 133 respondents highlighting their concern over this. Respondents felt that this process could be made be more prescriptive to enable like for like comparisons and develop a realistic understanding of the current position of the Scheme.

2.52 Under this question respondents discussed who the responsible body should be that produces and analyses the data, how the data can be made more comparable and transparent, and finally what additional data should be collected to enable this.

Who should be responsible for producing and analysing the data?

2.53 No consensus was reached as to who should be the responsible body that produces and analyses Scheme data. However, there was cross sector agreement that funds should be required to participate in any approach taken to improve transparency. Key suggestions included:

- The Department should continue to compile its statistical release about the Scheme, but the guidance notes should be improved and expanded, to ensure comparability between funds
- The Government Actuary's Department and the Chartered Institute for Public Finance and Accountancy could produce a standardised approach, after which the Department could analyse the data
- A central resource such as a national Scheme Standards Compliance Team could be established to work with the scheme advisory board to drive up data quality, consistency, standards and efficiency.
- Data could be collected and analysed by the Shadow Board, who could then advise the Secretary of State.
- An online data room or questionnaire could be used to capture points of interest, which could then be collated and analysed by a review body.
- CEM Benchmarking could be used across the Scheme to provide benchmarking analysis.

How can the data collected be made more transparent and comparable?

2.54 Most organisations suggested more detailed guidance or industry standards for data returns, publications and policies, to ensure a consistent approach was taken, especially for identifying administration costs and investment fees.

2.55 In terms of presentation, the vast majority of submissions suggested that all data should be published online to increase transparency, including triennial valuation statements and performance targets comparable to fees. Some fund authorities favoured a league table approach with the lowest performing quartile having to publically justify their position, after being given an opportunity to challenge draft data before it is published; thereby increasing public accountability.

2.56 It was widely recognised that the range of actuarial bases currently used renders factors such as risk tolerances, funding levels and contribution rates very difficult to compare. However, the benefit of using different actuarial valuations is being able to reflect each fund's particular circumstance, including their membership profile and deficits. It was suggested that consistent assumptions provided by the Government Actuary's Department would help develop comparable data, although this approach would not recognise the aforementioned reasons why the assumptions might differ in the first place. A range of proposals were made to address this issue:

- Run two valuations – one with fund specific assumptions to set employer contribution rates and a second to deliver comparable data.
- Make a comparison between funds of similar levels of maturity or investment strategy.
- Detail should be published on the main assumptions used and sensitivity analysis done to show the impact of changes in those assumptions.

2.57 In terms of investment and administration costs, respondents were concerned over their clarity and transparency. Currently the funds report an overall figure for investment costs and then for administration costs to the Department, but these are not broken down further to distinguish between different investment strategies and approaches. For example, there is no distinction as to whether a passive or active investment strategy has been followed, or whether the funds are externally or internally managed. It was suggested that collecting more detailed information should improve the transparency of fund data. The data suggested to be collected is listed in paragraph 2.59.

2.58 In addition, respondents noted that investment costs are very difficult to compare across funds. To make this comparison easier, some submissions suggested using a standard measure of basis points relative to assets under management. Others were keen to point out that each fund is subject to their own particular circumstances and choose to follow different strategies which lead to different fee levels. Some respondents were concerned that a standard measure of basis points relative to assets under management might be used to guide towards a common low cost strategy, and instead emphasised that investment costs should be seen in the context of whether the fund has achieved its objectives and required investment returns.

What additional data should be collected?

Investment and administration costs

2.59 Respondents suggested a range of measures that could be collected to improve the transparency of investment and administration costs, as well as investment performance. These included:

- More detailed administration costs, broken down into the main component parts and assessed against a range of quality measures;
- Asset management fees paid for each investment mandate, such as an asset class, and per each investment in a pooled fund
- Fees paid to investment consultants, independent advisers and custodians;
- The investment returns compared to their target, broken down by each investment mandate over several time periods to compare manager performance
- Performance assessed against a standard measure and then adjusted for different types of investment strategies.

2.60 In addition to determining standard costing methods for administration and investment fees, one organisation also suggested that administration costs arising from working with multiple employers should be examined. Many funds spend considerable time and money fulfilling the role of the employer, for example by tracking down missing member data. These costs are not consistently charged to employers and should be made clear.

Position of fund:

2.61 Respondents also suggested the following data should be publicised to make the position of each fund more transparent:

- Funding level of each fund and the Scheme in aggregate, including key underlying assumptions such as mortality rates and ill health rates.
- The data used by funds' actuaries to determine the current funding level and employers' contributions, for example the discount rate used and the anticipated rates of return underpinning the assumed necessary investment return
- Investment returns net of investment fees
- Cash flows reported on a consistent basis

> The Minister for Local Government has asked the Shadow Board to look at data transparency in more detail. It has already made progress, bringing together all of the funds' annual reports on their website. The Government is keen to support the Shadow Board in this work and looks forward to working with it to ensure more comparable data is available in the future.

Pension Fund Committee
Meeting to be held on 6 June 2014

Electoral Division affected:
None

Lancashire County Pension Fund – Annual Governance Statement 2013/14
(Appendix 'A' refers)

Contact for further information:
George Graham, County Treasurer's Directorate, (01772) 538102.
george.graham@lancashire.gov.uk

Executive Summary

In November 2013 Grant Thornton, the Fund's external auditors published a national report called "Coming of Age", which reflected on developments in the management of funds within the Local Government Pension Scheme. The Lancashire County Pension Fund is cited as an example of good practice in this report in a number of areas. One of the questions which the report asks Funds to consider is whether the Annual Governance Statement of the Administering Authority covers the activities of the Fund adequately.

The position in Lancashire, which will be replicated in most administering authorities, is that the Council's Annual Governance Statement makes no specific reference to the activities of the Fund. Therefore in response to this officers have developed a separate annual governance statement for the Fund which is presented for approval.

Recommendation

The Committee is recommended to approve the Annual Governance Statement for the Lancashire County Pension Fund, set out at Appendix 'A', for signature by the Chair and the County Treasurer.

Background and Advice

At its last meeting on 27 March 2014 the Pension Fund Committee considered a report from the External Auditors, Grant Thornton, on benchmarking work they had undertaken on the Fund's governance arrangements following the publication of their national review of the governance of LGPS funds in November 2013. This report highlighted two areas where the Lancashire County Pension Fund could improve its arrangements to bring them in line with best practice.

The first of these was concerned with the analysis of risk within a risk register, which was also considered by the Committee at its last meeting. The second concerns the annual review of the Fund's governance arrangements and control framework. In this area the LCPF was one of over 70% of funds where no reference to the operations

Lancashire County Council

of the Fund was made in the Annual Governance Statement of the Administering Authority (the County Council). It was also one of 97% of funds where the Fund did not produce a separate Annual Governance Statement. The exceptions to this are the two free-standing Pensions Authorities (in London and South Yorkshire), however these statements are concerned with the operation of the organisations rather than the management of the Pension Funds for which the organisations are responsible.

Importantly LGPS funds are not separate legal entities from their administering authority; hence the investments of the LCPF are made in the name of Lancashire County Council as administering authority for the Lancashire County Pension Fund. However, the Pension Fund is a substantial entity in its own right regardless of its legal status and it would be appropriate for any entity of this scale to carry out an annual review of its governance arrangements and control framework in order that "those charged with governance", in this case elected members, can be satisfied with the adequacy of the control environment in place.

In response to this officers have considered how such a review might best be conducted and concluded that the process of producing a separate annual governance statement for the Fund will provide members with the assurance required, as well as helpfully providing the County Council with added assurance about the control framework in a significant area of responsibility.

The process for compiling the statement has been undertaken by the Deputy County Treasurer who has responsibility for governance and compliance arrangements within the Fund. In order to compile the statement he has relied on assurance statement s provided by each senior manager who has responsibility for an element of the operation of the Fund which assess and examine performance against the various elements of the control framework as applied specifically to the running of the Fund. In addition the statement reflects the conclusions drawn by the Chief Internal Auditor from her work in relation to the Fund during the year, which is reported elsewhere on the agenda for this meeting of the Committee.

There is no precedent available for the style and format of a separate Annual Governance Statement for a local authority pension fund and therefore that used by the London Pension Fund Authority has been followed, although this is also quite similar to that of the County Council.

Consultations

Discussions have been held with the External Auditor in terms of the expectations flowing from their work referred to in this report.

Implications:

This item has the following implications, as indicated:

Risk management

A sound Annual Governance Statement which reflects the reality of the operation of the Fund represents a key assurance for members that the control framework is operating appropriately to manage risk.

Local Government (Access to Information) Act 1985
List of Background Papers

Paper	Date	Contact/Directorate/Tel
"Coming of Age: Development of the Local Government Pension Scheme" Grant Thornton	November 2013	George Graham County Treasurer's Directorate (01772) 538102

Reason for inclusion in Part II, if appropriate

N/A

Lancashire County Pension Fund –

Annual Governance Statement 2013/14

Introduction

The Lancashire County Pension Fund is a Pension Fund within the Local Government Pension Scheme (LGPS) which is a funded pension scheme created under the terms of the Superannuation Act 1972. Lancashire County Council is the body appointed under statute to act as the Administering Authority for the Fund.

At 31st March 2014 the Lancashire County Pension Fund provides a means of pension saving and retirement security for 150,917 members working for 279 employers and is one of the largest funds within the LGPS.

While the Fund is technically not a separate legal entity it does have its own specific governance arrangements and controls which sit within Lancashire County Council's overall governance framework. Given both the scale of the Pension Fund and the very different nature of its operations from those of Lancashire County Council more generally it is appropriate to conduct a separate annual review of the governance arrangements of the Pension Fund and this statement sets out that review.

The Pension Fund's Responsibilities

The Pension Fund is responsible for ensuring that its business is conducted in accordance with the law and proper standards and that what is, in effect, pensioners' money provided in large part from the public purse is safeguarded and properly accounted for. The Fund has a responsibility under local government legislation to make arrangements which secure continuous improvement in the way in which its functions are delivered.

In discharging this overall responsibility the Pension Fund is responsible for putting in place proper arrangements for the governance of its affairs and facilitating the effective exercise of its functions including arrangements for the management of risk.

The Fund has adopted its own Governance Policy Statement in line with the relevant regulations concerning the governance of funds within the LGPS. This statement has regard to relevant standards such as the Myners' principles. The Governance Policy Statement is available through the following link

http://www.yourpensionservice.org.uk/local_government/index.asp?siteid=5921&pageid=33736&e=e

In addition the operation of the Fund is subject to Lancashire County Council's Code of Corporate Governance which is consistent with the principles of the CIPFA/SOLACE Framework *"Delivering Good Governance in Local Government"*. The code is available from the County Council's website at the following link

http://www3.lancashire.gov.uk/corporate/atoz/a_to_z/service.asp?u_id=1821&tab=1

This statement sets out both how the Pension Fund has complied with its own Governance Policy Statement and Lancashire County Council's Code of Corporate Governance and also meets the requirements of the Accounts and Audit (England) Regulations which require all relevant bodies to prepare an annual governance statement.

The Purpose of the Governance Framework

The governance framework comprises the systems and processes, culture and values by which the Pension Fund is directed and controlled and the activities through which it engages with and informs stakeholders, including both fund members and employers. It enables the Fund to monitor the achievement of its strategic objectives and to consider whether those objectives have led to the delivery of appropriate and cost-effective outcomes.

The system of internal control is a significant part of that framework and is designed to manage risk to a reasonable level. It cannot, particularly in the investment context, eliminate all risk and can therefore only provide reasonable and not absolute assurance of effectiveness. The system of internal control is based on an ongoing process designed to identify and prioritise risks to the achievement of the Fund's objectives, to evaluate the likelihood of those risks being realised and the impact should they be realised, and to manage them efficiently, effectively and economically.

This statement reports on the annual review of the governance framework by officers which confirms that the framework has been in place within the Pension Fund for the year ended 31 March 2014.

The Fund's Governance Framework

The key elements of the systems and processes that comprise the Fund's governance framework are:

The identification and communication of the Fund's purpose objectives and intended outcomes to Fund members and employers.

The Fund has an established planning process focussed around the triennial actuarial review and the various teams providing services to the Fund produce annual service plans within the County Council's overall business planning framework.

Review of the Fund's objectives and intended outcomes and implications for the Fund's governance arrangements

Senior Managers review new and proposed legislation and the results of activities such as the triennial valuation on an ongoing basis and propose any necessary

changes either to objectives and outcomes or the governance arrangements to the Pension Fund Committee.

The Pension Fund Committee meets regularly and considers the various plans and strategies developed in order to meet the strategic objectives of the Fund and to monitor progress on the delivery of the strategic objectives.

All reports considered by the Pension Fund Committee identify how the key risks involved in any proposed decision and the nature of mitigation, together with any legal or other issues that might arise.

Measurement of the quality of services provided to Fund members and employers, ensuring they are delivered in line with the Fund's objectives and ensuring that they represent the best use of resources and value for money.

The Fund has three overall objectives and two specific investment objectives. These are reflected in the tasks included in the various team service plans for the year progress against which is measured through the County Council's overall performance management framework, which includes processes for monitoring and managing both individual and team performance.

Reports on the performance of the Investment Strategy (and consequently the results achieved by the Investment Management Team) are reported to each meeting of the Pension Fund Committee. This reporting focuses not just on the performance of investments but on the scale of the Fund's liabilities. Asset allocation strategies are as efficient as possible in providing the best returns (net of fees) for the appropriate amount of risk and an appropriate level of fees.

An annual report on the performance of the administration service is presented to the Pension Fund Administration Committee each year and made available to all Fund members and stakeholders. This report shows, amongst other things, performance against target for a range of industry standard process targets.

A programme of ongoing review of both procedures and processes is maintained and the cost of the administration service charged to the Fund is maintained below the lower quartile cost of comparable authorities as published by the Department of Communities and Local Government.

Definition and documentation of the roles and responsibilities of those involved in the management of the Fund with clear delegation arrangements and protocols for communication.

Clear job descriptions exist for all staff involved in the management of the Fund and the delivery of services to Fund members and employers, and together with appropriate guidance documents and constitutional documents such as the Governance Policy Statement provide the basis on which the management of the Fund is undertaken within a defined framework of procedural governance. Matters

reserved for the Pension Fund Committee and Senior officers are defined in the Governance Policy Statement and more widely (for example in relation to staffing matters) in the County Council's Constitution.

Development communication and embedding codes of conduct, definition of the standards of behaviour for members and staff.

These matters are defined in law and the various codes of conduct and protocols contained within the County Council's constitution. Staff are reminded of the requirements of these codes on a regular basis, while specific training in relation to matters such as declarations of interest is provided to elected members following each set of County Council elections.

Review of the effectiveness of the Fund's decision making framework including delegation arrangements and robustness of data.

The interaction between the Pension Fund Committee and the Investment Panel, including levels of delegation, has been reviewed and revised to better meet the needs of the Fund in terms of effective delivery of the Investment Strategy, and this is reflected in specific reporting arrangements in relation to investment activity. These arrangements will be reviewed in the light of the new statutory and regulatory framework that will be put in place by April 2015.

The development of a more liability aware investment strategy and changes in the arrangements for data collection from fund employers will increase the amount and quality of information available to support decision making and therefore serve to strengthen the decision making process.

Review and update of standing orders, standing financial instructions, a scheme of delegation and supporting procedure notes / manuals which define how decisions are taken and the processes and controls required to manage risks.

At the top level these requirements are set out in the Governance Policy Statement and within the County Council's Constitution. These are reviewed on a regular basis and are supported by a range of detailed materials appropriate to specific activities.

The management of risk is central to the Fund's activities and efforts have been made to formalise the Fund's risk register as well as increase awareness of risk in various contexts including:

- Investment decision making
- Project Management and Delivery
- Data Quality
- Fund Employer Risks

Fulfilling the core functions of an Audit Committee

In relation to the Fund this role is performed by Lancashire County Council's Audit and Governance Committee, which conducts an annual review of its effectiveness in the undertaking this role.

The ensuring of compliance with relevant laws and regulations, internal policies and procedure and that expenditure is lawful

The key area of compliance from an operational point of view is with the various Local Government Pension Scheme Regulations covering both the structure and benefits payable by the Fund and the investment of funds.

Compliance with the Scheme Regulations is ensured by a dedicated technical team and the use of a pensions administration system specifically designed for the LGPS.

The Fund's investments are managed in line with the relevant regulations with independent assurance in relation to compliance provided both by the Fund's custodian and an Investment Compliance Team which is managerially independent from the Investment Management Team.

The Fund and its officers must also comply with a range of other laws and regulations applicable either to local authorities generally or to any organisation. These are managed through the specific accountabilities of individual managers or through the wider County Council's business processes with the Monitoring Officer providing advice on the impact of legislative changes when necessary.

The basic system of financial control mirrors that of Lancashire County Council, and is centred on principles of appropriate segregation of duties, management supervision, delegation and accountability.

Managers undertake maintenance of and input into the system, including review and reporting of actual performance against plans and budgets in the context of investments, administration and accounting.

The system of internal financial control can provide only reasonable and not absolute assurance that assets are safeguarded, that transactions are authorised and properly recorded, and that material errors or irregularities are either prevented or would be detected in a timely manner.

The Fund participates in the National Fraud Initiative, previously managed by the Audit Commission and actively investigates all data matches found as a result of this process. The results of this work are reported to the Pension Fund Committee. More generally Lancashire County Council's procedures for investigating allegations of fraud and corruption apply equally to the Fund.

Whistle blowing and receiving and investigating complaints from the public

The Fund is covered by the County Council's whistle blowing policy, the effectiveness of which is reported to the Audit and Governance Committee annually.

Complaint handling is carried out in line with either the Internal Dispute Resolution Procedure (in relation to complaints by members in relation to the level of benefit awarded) or the County Council's complaints procedure (in relation to other matters). These policies are publicly available and the numbers and outcomes of complaints under the Internal Dispute Resolution Procedure are reported annually in the Annual Administration Report.

Identifying the development needs of members and senior officers in relation to their roles and supporting them through appropriate training.

Elected members undertake training needs analysis linked to the CIPFA Knowledge and Skills Framework. This has resulted in the provision of access to a range of specific reading material and the provision of a programme of learning opportunities targeted at specific areas of identified need. In addition prior to major decisions coming before the Pension Fund Committee topic based training relating to the decision at hand is provided. The delivery of this programme is the responsibility of the Head of Investment Compliance.

All staff are subject to an annual appraisal process which identifies specific training requirements and any knowledge gaps relevant to their role. Staff who are members of professional bodies also have ethical obligations to undertake Continuing Professional Development relevant to their role.

Establishment of clear channels of communication with all stakeholders ensuring accountability and encouraging open consultation.

The Fund maintains a Communications Policy Statement as part of its policy framework which sets out the way in which the Fund will engage with specific audiences and on what issues. The key channels of communication are:

- Newsletters for active, deferred and pensioner members;
- Campaign materials focussed around scheme changes;
- Workshops, conferences and guidance materials provided to employers
- The Fund's website, which contains an increasing transactional capability.
- An annual "brief" for Finance Directors of employer organisations providing information on the performance of the Fund and an update on specific issues of interest, such as the triennial valuation.
- The publication of committee papers, minutes and various annual reports and policy documents on the internet.

The Incorporation of good governance arrangements in respect of partnerships and other group working and reflecting these in the Fund's overall governance arrangements.

The Fund is bound by Lancashire County Council's partnership protocol, which highlights the need for such arrangements to reflect good practice in terms of governance. The Fund itself has a limited number of "partnerships", which are largely in the form of jointly procured contracts for the provision of services for which suitable governance arrangements are in place. However, for all arrangements where there is a relationship between the Fund and another organisation the Fund seeks to spell out clearly the expectations and requirements on each party, whether in contractual form where appropriate or through a form of "service level agreement" where a contract is not appropriate.

The Fund seeks to comply with the principles set out in CIPFA's Statement "The Role of the Chief Finance Officer in Local Government", and the arrangements within Lancashire County Council comply with the principles of this statement. The Fund, however, is not a local authority in its own right and therefore the applicability of some elements of the statement within the context of the Fund is limited. The County Treasurer, as the County Council's Chief Finance Officer, is separately appointed by the Full Council as Treasurer to the Lancashire County Pension Fund and consequently the Chief Officer responsible for fulfilling the County Council's duties as administering authority.

The Fund seeks to comply with the requirements of CIPFA's Knowledge and Skills Framework. Training is ongoing and will continue to be focussed on the needs identified through an analysis of training needs.

The Fund has, in line with the relevant LGPS regulations taken steps to separate its banking arrangements from those of the County Council and these have been reviewed by both internal and external auditors and been seen to be satisfactory. The Fund is also continuing to develop the way in which it uses its accounting system in order to gain greater efficiency in back office operations and make tasks such as accounts preparation easier.

Review of Effectiveness

The Pension Fund Committee is responsible for conducting, at least annually, a review of the effectiveness of its governance framework, including the system of internal control. The review of effectiveness is informed by the work of the senior managers responsible for the delivery of the Fund's various activities, who have a responsibility for the maintenance and development of the governance environment, the Chief Internal Auditor's annual report, and also reports of the external auditor and other review agencies such as the Pensions' Regulator and Pensions' Ombudsman.

The key planned activities of the Fund during 2013/14 were:

- Effective induction and establishment of a new Pension Fund Committee following the County Council elections in May 2013.
- Effective implementation of LGPS 2014
- The completion of the 2013 Actuarial Valuation with associated changes in the Funding Strategy Statement.
- The continuation of the transition of assets into the allocations flowing from the 2010 Investment Strategy following the completion of market research and procurement processes.

The Committee has overseen each of these processes and has continued the Governance arrangements of its predecessor which delegate executive authority to officers in appropriate circumstances with effective accountability and scrutiny arrangements. This process has embedded the arrangements agreed by the previous Pension Fund Committee which are set out in the Governance Policy Statement. In particular the Committee has reviewed and approved a formalisation of the Fund's overall arrangements for the management of the different categories of risk to which it is exposed.

The Pension Fund Administration Sub Committee is responsible for monitoring the performance of the administration service and agreeing various key policies in this area on behalf of the Committee. The Sub Committee has reviewed a number of key policies including the Pensions Administration Strategy Statement and the Communications Policy Statement in the light of the LGPS 2014 reforms.

The Investment Panel ensures that appropriate due diligence is undertaken on new investments and ensures that they comply with the LGPS Investment Regulations. The Panel is chaired by the Treasurer and includes the Fund's two Independent Investment Advisers. The Panel continues to operate under delegated authority from the Pension Fund Committee.

Lancashire County Council's Democratic Services Team is responsible for supporting the Committee and its chair in managing Committee, Sub Committee and Investment Panel meetings. The County Secretary and Solicitor as the County Council's Monitoring Officer carries the same responsibilities in relation to the Fund.

The Fund's Internal Audit Service is provided by the County Council's Internal Audit Service and the Chief Internal Auditor is managerially accountable to the County Treasurer. The Chief Internal Auditor provides both a separate annual audit plan and annual report to the Pension Fund Committee, which are subject to approval by the Committee. The work of Internal Audit is carried out:

- In accordance with the standards set out in relevant professional guidance promulgated by CIPFA and the Institute of Internal Auditors and the requirements of International Public Sector Auditing Standards.

- Informed by an analysis of the risks to which the Fund is exposed. The Internal audit plan is developed with and agreed by the Chief Internal Auditor and the various senior managers responsible for aspects of the Fund's operations.

- During the year the Chief Internal Auditor's reports include Internal Audit's opinion on the adequacy and effectiveness of the Fund's system of control.

The Chief Auditor's Annual Report for 2013/14 indicates that she is able to provide substantial assurance over the controls operated by the Fund.

External audit of the Fund is provided by Grant Thornton who were appointed by the Audit Commission as a consequence of being appointed as auditor for Lancashire County Council.

- The work is performed to comply with international auditing standards.

- The auditors take a risk based approach to audit planning as set out in the Code of Audit Practice. Grant Thornton will report on the audit of the Fund's financial statements.

- The audit will include a review of the system of internal control and the Annual Governance Statement within the context of the conduct of those reviews relating to the County Council.

- Grant Thornton were appointed for five years following a procurement process managed by the Audit Commission.

Actions Planned for 2014/15

The following specific actions are proposed for completion during 2014/15.

- To work with the Pension Fund Committee to define more clearly the overall objectives and strategic planning framework for the Fund;

- To review and refresh, as necessary, those elements of the Fund's policy framework that have not yet been subject to review as part of the process of introducing LGPS 2014.

- To review the Fund's governance arrangements in the light of the Government's proposals for reform as part of LGPS 2014, including preparation for the new role for the Pensions' Regulator.

- To develop and begin the implementation of a more "liability aware" strategy for the management of the Fund's investments, in particular reflecting the individual circumstances of employing organisations;

- To embed the processes associated with the Fund's risk register in the management of the Fund.

- To review the transparency and scale of charges made by the County Council for services provided to the Fund.

- To produce a formal Compliance Manual for the Fund consolidating currently disparate guidance notes and memoranda.

- To formalise the arrangements for the management of the Fund's internal cash holdings by County Council staff into a clear investment mandate.

Signed

County Councillor Terry Burns

Chair of the Pension Fund Committee

Gill Kilpatrick

Treasurer to the Lancashire County Pension Fund

Date:

Pension Fund Committee
Meeting to be held on 6 June 2014

Electoral Division affected: All

Your Pension Service - Annual Administration Report
(Appendix 'A' refers)

Contact for further information:
Diane Lister (01772) 534827, Your Pension Service
Diane.lister@lancashire. gov.uk

Executive Summary

This annual administration report is produced in accordance with the Service Level Agreement (SLA) for the provision of pension administration services to Lancashire County Pension Fund. The report describes the performance of Your Pension Service against the standards set out in the SLA during 2013/14.

Recommendation

The Committee is asked to note the 2013/14 Administration Report as presented at Appendix 'A'.

Background and Advice

The Pension Fund Committee is required to receive regular reports from the Treasurer to the Fund on the administration of the Fund to ensure that best practice standards are satisfied and met and to satisfy itself that and justify to all stakeholders, including Fund Employers, that the Fund is being run on an efficient and effective basis.

A Service Level Agreement (SLA) exists between Lancashire County Council and the service provider; Your Pension Service. The SLA contains specific service level standards and corresponding service level targets. A report is attached at Appendix 'A' to inform the Committee of the Service's performance against the standards and targets set over the year to 31 March 2014.

Consultations

N/A

Implications:

N/A

Lancashire County Council

Local Government (Access to Information) Act 1985
List of Background Papers

Paper	Date	Contact/Directorate/Ext
N/A		

your pension service

LANCASHIRE COUNTY PENSION FUND

Annual Administration Report 2014

Lancashire County Council

comms:3677

1. INTRODUCTION

Purpose

This annual administration report is produced in accordance with the Service Level Agreement (SLA) for the provision of pension administration services to Lancashire County Pension Fund. The report describes the performance of Your Pension Service (YPS) against the standards set out in the SLA during the year.

Review of the Year

2013 has been a busy year of planning and preparation for the new LGPS2014. This began with a communication campaign to encourage members to make use of the Service's "My Pension Online" self service facility. This facility will be a key communication channel in the future and has been used to communicate the 2014 Scheme changes.
LGPS2014 Roadshows were hosted at 27 locations across Lancashire. Approximately 3,000 Scheme members have attended these events. The Roadshow was also webcast to make it available to all members and has received over 3,800 hits to date.

Your Pension Service was delighted to be awarded the Quality of Service award at the Local Government Chronicle Investment Awards held in December. This award focuses upon the service provided to internal and external customers and on new developments that enhance quality in the delivery of financial services.

Annual Plan – 2013/14

Event	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar
Responsibility Your Pension Service (YPS)												
Application of Pension Increases		Completed										
Issue Annual Benefit Statement to Active Members						Completed						
Issue Annual Benefit Statement to Def Members		Completed										
Issue P60s to Pensioners	Completed											
Issue Newsletter	Completed											
Complete HMRC Scheme Returns										Completed		
Provide FRS17 data											Completed	

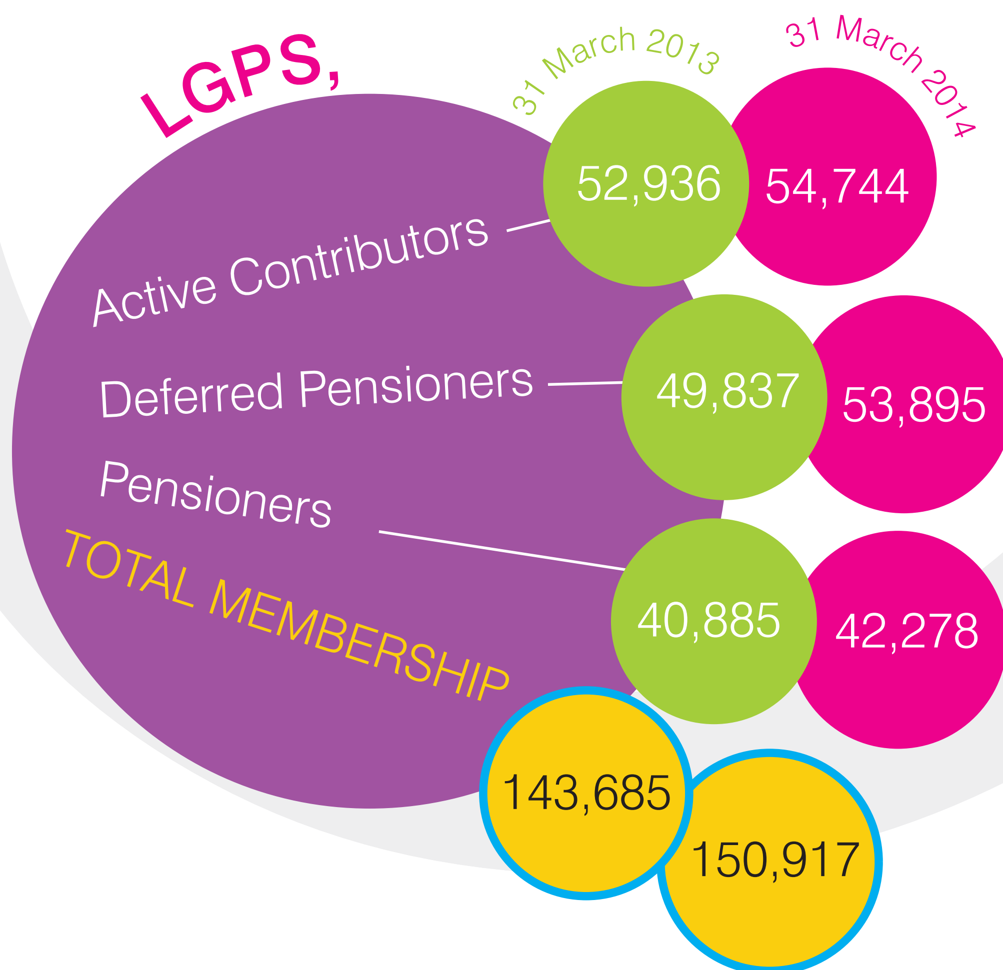
2. PERFORMANCE

Annual Benefit Statements

Over the year the service produced over 100,000 online benefit statements for active and deferred Scheme members. Annual newsletters were posted online alongside the statements. Email alerts were also sent to Scheme members who had signed up to "My Pension Online" to promote the Roadshows and raise awareness of the 2014 Scheme changes.

Membership

Membership of the fund has increased overall by 5% over the year.

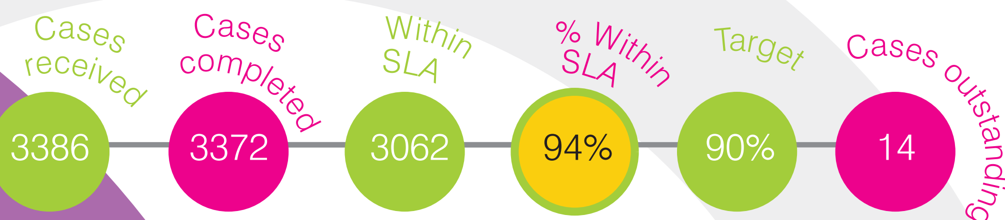
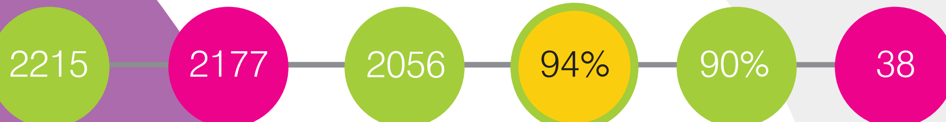
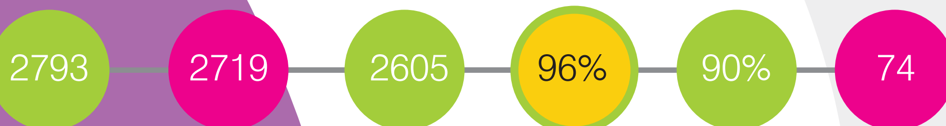
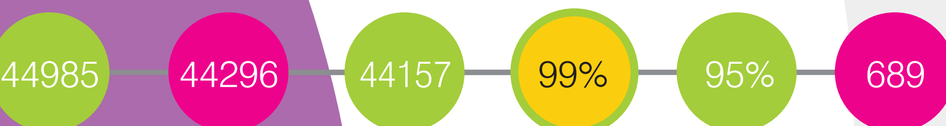


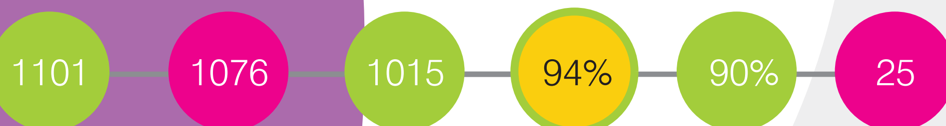
Performance

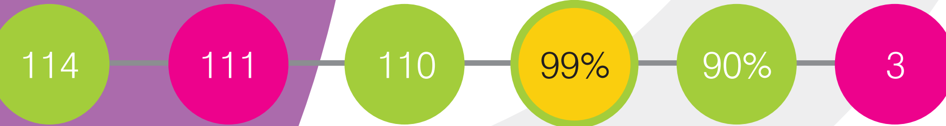
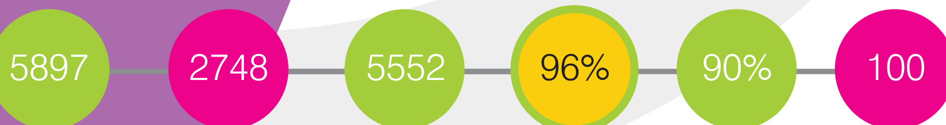
Performance continues to exceed SLA targets and the Service consistently exceeds its key performance indicator; 'to calculate and pay all retirement benefits within 10 working days'. Overall achievement against SLA targets over the year was 98%. The Service has experienced an unprecedented increase in workload since November 2013 and the launch of LCC's Budget Challenge exercise. More than 1,300 VR estimates were processed between November 2013 and March 2014.

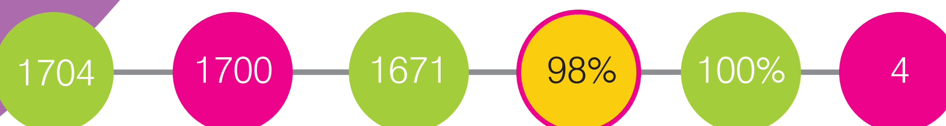
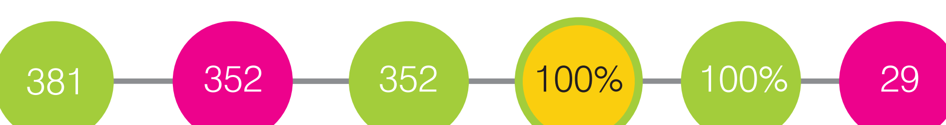
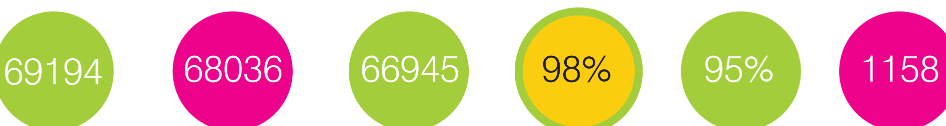
LGPS

During the reporting period 68,036 individual calculations/enquiries were completed, of which 66,945 met the performance standard;an overall performance of 98% was achieved.

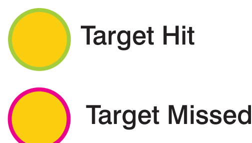







Performance Standard	Cases received	Cases completed	Within SLA	% Within SLA	Target	Cases outstanding
Estimate benefits within 10 working days	3386	3372	3062	94%	90%	14
Payment of retirement benefits within 10 working days	2215	2177	2056	94%	90%	38
Payment of death benefits within 10 working days	2793	2719	2605	96%	90%	74
Implement change in pensioner circumstance by payment due date	44985	44296	44157	99%	95%	689
Respond to general correspondence within 10 working days of receipt	2600	2529	2418	96%	90%	71
Action transfers out within 10 working days	1101	1076	1015	94%	90%	25
Action transfers In within 10 working days	1242	1159	1111	96%	90%	83
Pay Refunds within 10 working days	114	111	110	99%	90%	3
Provide leaver statement within 10 days	5897	2748	5552	96%	90%	100
Amend personal records within 10 working days	2776	2748	2717	99%	95%	28
VR Estimates	1704	1700	1671	98%	100%	4
VR Payments	381	352	352	100%	100%	29
	69194	68036	66945	98%	95%	1158



3. CUSTOMER SERVICE

Partnership Events

During the year the Service's dedicated Partnerships Team undertook a variety of events, courses and presentations. In addition the Team visited a number of employers to maintain and improve working relationships. Not surprisingly communication of the new LGPS2014 was top priority during the year and, as well as hosting Roadshows, the Team also hosted employer training events with payroll and HR practitioners from employers across Lancashire in attendance.

The Service's annual employer conference was held at Woodlands on 6th November. The main topic was of course the new LGPS2014. The event showcased the new way of working with employers and the monthly submitting of data via the new employer portal; EPIC.
The annual Directors Brief for Chief Finance Officers was held in December. The Fund Actuary attended to report the initial results of the 2013 triennial valuation. The briefing was followed up with one-to-one surgeries for employers to discuss the financial impact of the results upon their organisation.

AskPensions

A dedicated pension's helpdesk is the first point of contact for both Scheme members and employers. Over the year 90% of calls were successfully answered, meeting the SLA target. A dip in service was experienced at the beginning of the year due to the introduction of online P60s alongside the promotion of "My Pension Online". This led to a large increase in calls from pensioners. The Partnerships Team held 'Drop In' sessions at libraries across Lancashire in response to the increase in calls. Performance recovered significantly over the last quarter when 96% of calls were successfully answered.

4. LEGISLATIVE CHANGE

During the year significant legislative change encompassed the introduction of the new Local Government Pension Scheme with effect from 1 April 2014.

The Public Service Pensions Act received royal assent on 25 April 2013 setting out the new legal framework for public service pension schemes, including the LGPS. The Act reflects the recommendations made by the Independent Public Service Pension Commission chaired by Lord Hutton.
After completing a statutory consultation in August 2013, legislation outlining the LGPS rules from 1 April 2014 was made to provide:

- a pension scheme design based on career average pay
- an accrual rate of 1/49th of pensionable pay
- revaluation of benefits in line with the CPI
- a Normal Pension Age equal to State Pension Age
- an average contribution rate of 6.5%
- a new low cost 50/50 option where half the contribution rate can be paid in return for half the benefits
- a vesting period of two years

Later in the year legislation was passed to remove access to the Scheme for new councillors from 1 April 2014. Existing councillor members as at 31 March 2014 will leave the Scheme at the end of their current fixed term of office.

5. APPEALS

Members who disagree with decisions taken by their employer or administering authority may appeal using the Internal Dispute Resolution Procedure (IDRP) under the LGPS rules.

The IDRP is a formal appeal procedure which contains two stages. The first stage allows the person to ask the body who originally made the decision to review it, i.e. either the employer or the administering authority. The second stage allows the person, if they are not satisfied with the outcome at the first stage, to ask the Appeals Officer at the administering authority to review the disagreement. The Appeals Officer for Lancashire County Council is the Deputy County Treasurer.

During the year, 7 second stage appeals were received, which mainly concerned the Scheme's ill health retirement provisions. The Appeals Officer has dismissed 4 and upheld 2 of these appeals with 1 currently ongoing.

6. e-DEVELOPMENT

EPIC

Your Pension Service has worked closely with BT Lancashire Services to develop a solution to meet the additional demands of the LGPS2014.
The solution will: -

- Record career average pay accurately for all scheme members
- Improve reconciliation of employee and employer contributions
- Ensure that all auto enrolled members are captured correctly
- Improve overall data quality within the Altair Pensions administration system
- Manage and monitor the receipt of employer returns more effectively on a monthly 'real time' basis.

The new Employer Payroll Information Collection "EPIC" system has been in developed to take data securely from employers and will enable YPS to regularly upload contributions and pensionable pay. The system will ensure that contributions and career average pay reconcile with payments made, and are recorded on individual pension accounts accurately.
Support and guidance has been provided to employers. The first data collection files are due at the end of April 2014.

Employer Services

Employer Services is an online tool to allow employers to access their own employees' records. It enables them to check personal and financial data, and run benefit estimates without the need to contact YPS. The service was launched in December 2013.
The benefits of Employer Services include the mitigation of estimates requests, access to immediate benefit estimates and early retirement costs for employers, and an increase in employer interest and knowledge of pensions. Over the next few months Employer Services will continue to be promoted alongside EPIC.

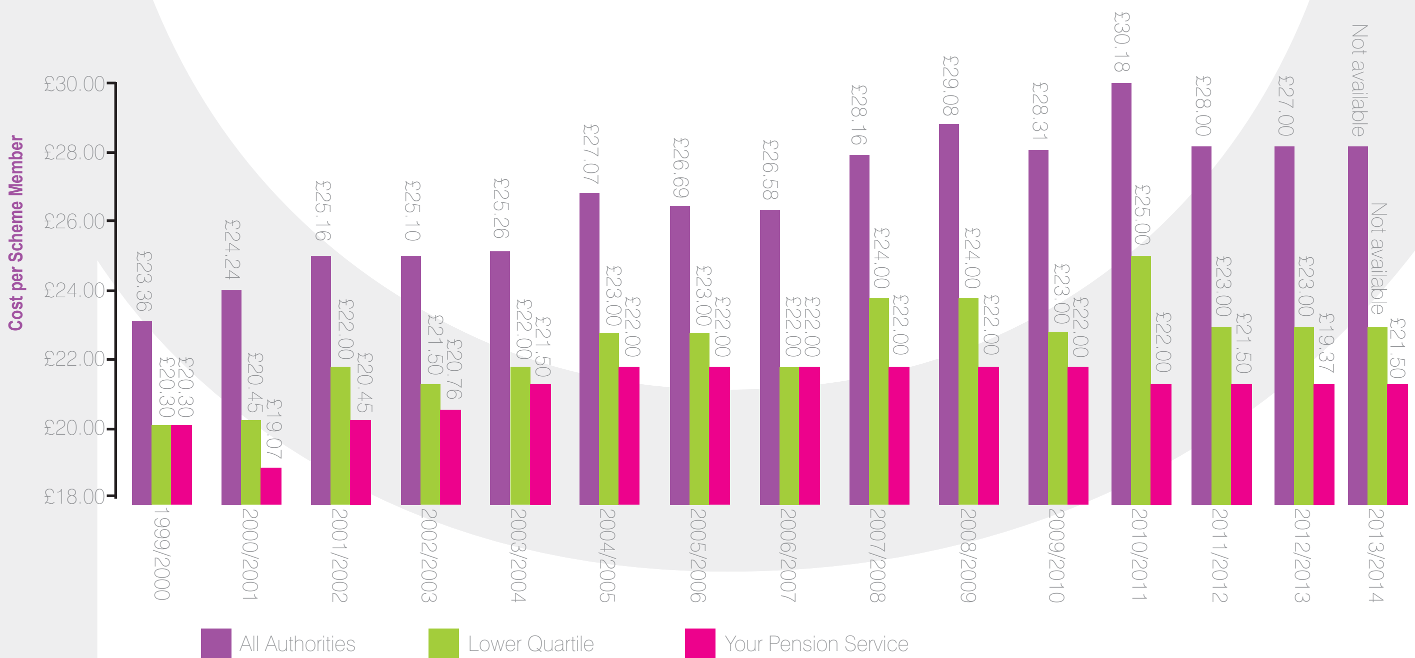
Immediate Payments

Your Pension Service pays monthly pensions using the Altair payroll system. The payroll system also incorporates the facility to make ad hoc payments to members. This facility is currently being developed and is due to be launched at the end of May 2014.

Implementation of this facility will allow the quick and efficient payment of retirement lump sums, death grants, transfers and refunds out of the Fund. This new development will reduce costs as there will no longer be a need to use the Councils Accounts Payable service.

7. CHARGES

Your Pension Service makes a charge to the Pension Fund on a per member basis which is restricted to the lower quartile as reported in national benchmarking returns. This charge is currently set at £21.50 per member as against a benchmark of £23.00. The ongoing level of charge to the Fund will be kept under review.



Pension Fund Committee
Meeting to be held on 6 June 2014

Electoral Division affected:
None

Shareholder Voting and Engagement
(Appendices 'A' and 'B' refer)

Contact for further information:
Andrew Fox, (01772) 535916, County Treasurer's Directorate,
Andrew.fox@lancashire.gov.uk

Executive Summary

In accordance with its policies on promoting corporate social responsibility in the businesses in which it invests, the Fund seeks to influence companies' behaviour and ensure sound governance principles. The Fund achieves this through engaging Pensions and Investment Research Consultants Ltd (PIRC) as its Governance Adviser and also through the Local Authority Pension Fund Forum (LAPFF).

This report provides the latest quarterly update for the Committee on the work undertaken on the Fund's behalf by PIRC and the engagement activity undertaken by LAPFF.

The attached report from PIRC (Appendix A) covers the period 1 January 2014 to 31 March 2014. The Fund has voted on 535 occasions and has opposed or abstained in 34% of votes. PIRC recommends not supporting resolutions where it does not believe best governance practice is being applied. PIRC's focus has been on promoting independent representation on company boards, separating the roles of CEO and Chairman and ensuring remuneration proposals are aligned with shareholders' interests.

Details of the holdings of the Pension Fund in relation to the meetings held in this period are also given to provide more contextual information regarding the geographical and sector spread of the shareholder interests.

The attached engagement report from LAPFF (Appendix B) also covers the period 1 January to 31 March 2014.

Details of potential class actions in relation to companies in which Lancashire County Pension Fund currently owns shares or has previously owned shares is also set out in the report.

Recommendation

The Committee is asked to note note the report.

Background and Advice

Lancashire
County
Council

Shareholder Voting and Governance

PIRC, acts as the Fund's proxy and casts the Fund's votes at shareholder meetings. PIRC are instructed to vote in accordance with their guidelines unless the Fund instructs an exception. PIRC analyses investee companies and produces publically available voting recommendations to encourage companies to adhere to high standards of governance and social responsibility.

The analysis includes a review of the adequacy of environmental and employment policies and the disclosure of quantifiable environmental reporting. PIRC is also an active supporter of the Stewardship Code, a code of practice published by the Financial Reporting Council with the aim of enhancing the quality of engagement between institutional investors and companies.

PIRC also lobbies actively on behalf of its investing clients as well as providing them with detailed support. It works closely with NAPF (the National Association of Pension Funds) and LAPFF (the forum of Local Authority Pension Funds). The Lancashire County Pension Fund is a member of both these organisations.

PIRC's quarterly report to 31 March 2014 is presented at Appendix A. This report not only provides details of the votes cast on behalf of the Fund but also provides a commentary on events during the period relevant to environmental social and governance issues. It should be noted that if the Fund so wished, it retains the ability to cast a vote which does not accord with PIRC's recommendations.

The Fund's voting record using PIRC as its proxy for the three months ended 31 March 2014 is summarised below:

GEOGRAPHIC VOTING OVERVIEW

Geographic Region	Meeting	Resolutions	For	Oppose	Abstain	Withheld	Non-Voting
SOUTH AND CENTRAL AMERICA	1	3	2	1	0	0	0
REST OF THE WORLD	0	0	0	0	0	0	0
ASIA	3	13	1	0	12	0	0
NORTH AMERICA	18	253	146	82	7	17	0
UK	4	41	36	2	3	0	0
EU	7	184	91	51	25	0	17
JAPAN	2	41	38	3	0	0	0

ANALYSIS OF UK ALLSHARE VOTING RECOMMENDATIONS

Resolution Type	For		Abstain		Oppose		Total
	No.	%	No.	%	No.	%	
Annual Reports	2	100.0	0	0.0	0	0.0	2
Remuneration Reports	1	50.0	0	0.0	1	50.0	2
Articles of Association	1	100.0	0	0.0	0	0.0	1
Auditors Appointment	0	0.0	2	100.0	0	0.0	2
Directors	15	100.0	0	0.0	0	0.0	15
Dividend	2	100.0	0	0.0	0	0.0	2
Executive Pay Scheme	0	0.0	0	0.0	0	0.0	0

The Fund was party to 535 resolutions during this period, of which 59% resulted in positive votes for shareholder resolutions and 34% were opposed or an abstention given. Voting abstention is regularly used by institutional investors as a way of signalling a negative view on a proposal without active opposition. In addition, within certain foreign jurisdictions, shareholders either vote for a resolution or not at all, opposition to these votes is described as vote withheld. These totalled 17 within the period, just over 3%. The remaining agenda items required no vote.

Details of the votes made on the Fund's behalf during the period are set out in the following table, and gives the company name, the date of the meeting, the meeting type (typically Annual General Meeting (AGM) or Extraordinary General Meeting (EGM)), the country of incorporation, primary market sector, the value of Lancashire's holding in each company, and the voting details.

At the previous Pension Fund Committee meeting in March 2014, a question was raised regarding the overall outcomes of the resolutions that PIRC has voted on the Fund's behalf. Producing this information is considered to be an important measure of the effectiveness of voting activity by the Fund. Fund officers have taken this feedback to PIRC as this information has not previously been available to individual Funds and PIRC are currently working on this development. The information will be reported to future meetings of the Committee when it becomes available.

Lancashire County Pension Fund voting details January - March 2014

Company	Date	Type	Country	Sector	Holding £	Resolution Count	For	Oppose	Abstain	Withhold	Withdrawn	Non-Voting
INTUIT INC.	23/01/2014	AGM	United States	Software	2,362,089.21	12	6	6	0	0	0	0
SK HYNIX	21/03/2014	AGM	South Korea	Semi Conductors	3,589,860.98	6	0	0	6	0	0	0
BM&F BOVESPA SA	24/03/2014	AGM	Brazil	Diversified Financial Services	4,876,593.34	3	2	1	0	0	0	0
ROCHE HOLDING AG	04/03/2014	AGM	Switzerland	Pharmaceuticals	22,595,258.66	33	19	14	0	0	0	0
QUALCOMM INC.	04/03/2014	AGM	United States	Communications	8,159,643.21	17	9	7	0	0	0	0
APPLIED MATERIALS INC	04/03/2014	AGM	United States	Semi Conductors	6,582,315.53	15	14	0	1	0	0	0
CAPITOL FEDERAL FINANCIAL INC	21/01/2014	AGM	United States	Thrifts & Mortgage Finance	1,838,292.78	5	1	1	0	3	0	0
BECTON DICKINSON & CO	28/01/2014	AGM	United States	Health Care Equipment & Supplies	2,585,781.33	19	7	11	1	0	0	0
SVENSKA HANDELSBANKEN	26/03/2014	AGM	Sweden	Banks	14,658,329.62	23	15	2	3	0	0	3
DOLBY LABORATORIES INC	04/02/2014	AGM	United States	Electronic Equip, Instru & Components	9,006,101.19	11	5	1	1	4	0	0
CANON INC	28/03/2014	AGM	Japan	Tech. Hardware, Storage & Peripherals	7,404,529.15	25	22	3	0	0	0	0
JYSKE BANK	19/03/2014	AGM	Denmark	Banks	4,813,398.05	45	11	19	9	0	0	6
WALT DISNEY CO.	18/03/2014	AGM	United States	Media	25,505,930.40	15	8	7	0	0	0	0
TE CONNECTIVITY LTD	04/03/2014	AGM	United States	Electronic Equip, Instru & Components	10,589,071.73	30	26	4	0	0	0	0
DEERE & CO.	26/02/2014	AGM	United States	Machinery	4,948,998.65	13	6	6	1	0	0	0
VODAFONE GROUP PLC	28/01/2014	EGM	United Kingdom	Wireless Telecommunication Services	2,370,969.94	4	4	0	0	0	0	0
VODAFONE GROUP PLC	28/01/2014	COURT	United Kingdom	Wireless Telecommunication Services	2,370,969.94	1	1	0	0	0	0	0
SAMSUNG ELECTRONICS CO LTD	14/03/2014	AGM	South Korea	Semi Conductors	20,367,645.25	2	1	0	1	0	0	0
ORION CORP	25/03/2014	AGM	Finland	Pharmaceuticals	1,854,666.86	16	8	0	1	0	0	7
PT BANK NEGARA INDONESIA	06/03/2014	AGM	Indonesia	Banks	2,393,335.31	5	0	0	5	0	0	0
ACCENTURE PLC	30/01/2014	AGM	United States	IT Services	22,962,170.33	17	11	6	0	0	0	0
YAMAHA MOTOR CO LTD	25/03/2014	AGM	Japan	Automobiles	5,669,160.92	16	16	0	0	0	0	0
SCHINDLER HOLDING AG	17/03/2014	AGM	Switzerland	Machinery	9,171,751.43	23	9	11	3	0	0	0
METRO INC -CL A	28/01/2014	AGM	Canada	Food & Staples Retailing	1,777,582.62	20	11	2	0	7	0	0
VISA INC	29/01/2014	AGM	United States	IT Services	32,335,687.51	13	12	1	0	0	0	0
MCCORMICK & CO	26/03/2014	AGM	United States	Food Products	2,099,938.09	12	6	6	0	0	0	0
SHAW COMMUNICATIONS INC-CL B	14/01/2014	AGM	Canada	Media	2,133,386.08	17	10	6	1	0	0	0
WH SMITH PLC	22/01/2014	AGM	United Kingdom	Specialty Retail	3,474,913.62	16	14	1	1	0	0	0
AMDOCS LTD	30/01/2014	AGM	United States	IT Services	2,452,376.66	15	6	8	1	0	0	0
VERIZON COMMUNICATIONS INC	28/01/2014	EGM	United States	Diversified Telecommunication Services	4,950,971.87	3	1	1	1	0	0	0
IMPERIAL TOBACCO GROUP PLC	05/02/2014	AGM	United Kingdom	Tobacco	7,301,686.27	20	17	1	2	0	0	0
FRANKLIN RESOURCES INC	12/03/2014	AGM	United States	Capital Markets	7,367,426.60	14	6	8	0	0	0	0
CARLSBERG AS	20/03/2014	AGM	Denmark	Beverages	7,581,432.25	22	10	3	8	0	0	1
TD AMERITRADE HOLDING CORP	12/02/2014	AGM	United States	Capital Markets	15,408,796.57	5	1	1	0	3	0	0
NOVARTIS AG	25/02/2014	AGM	Switzerland	Pharmaceuticals	4,710,452.14	22	19	2	1	0	0	0
						535	314	139	47	17	0	17

Shareholder Engagement through LAPFF

Lancashire County Pension Fund is also a member of the Local Authority Pension Fund Forum (LAPFF), which exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders whilst promoting social responsibility and corporate governance at the companies in which they invest.

Members of the Committee may be interested to note the attached engagement report from LAPFF (Appendix B) which covers the period 1 January 2014 to 31 March 2014.

It sets out details of their activities in influencing governance, employment standards, reputational risk, climate change, finance and accounting, and Board composition, and provides a slightly different and wider perspective than the PIRC report.

Class Actions

United States

The Fund has appointed Barrack, Rodos and Bacine (BR&B) and, more recently in addition, Robbins Geller Rudman and Dowd (RGRD) to provide class action monitoring with the aim of ensuring that the Lancashire County Pension Fund receives all monies due to the Fund by filing its proof of claim from these cases. These services are at no cost to the Fund.

BR& B and RGRD will identify class actions where the Fund has a potential loss arising from an alleged fraud or a securities law violation. This is achieved through their respective monitoring systems which follows each potential securities case from the beginning to the end by ensuring its filing of the proof of claim so that the Fund may receive its payment.

Occasionally the Fund may be asked to participate in a class action, and/ or to apply to become the lead or co-lead plaintiff, but under US law any shareholder subject to such a loss will be automatically entered into and benefit from a class action without having to file an individual claim.

Details of current potential cases from BR&B as at 31 March 2014 are set out below.
:

Company name	Effective class period begin	Effective class period end	Potential loss incurred ($'000)
Medtronic, Inc	08/12/10	03/08/11	27.71
CenturyLink, Inc.	08/08/12	14/02/13	521.63
Barrick Gold Corp.	07/05/09	23/05/13	411.36
Intuitive Surgical, Inc.	19/10/11	18/04/13	251.54
ITT Educational Services, Inc.	24/04/08	25/02/13	760.06
Weightwatchers International	14/02/12	30/10/13	2,265.97

United Kingdom

Unlike class actions within the US jurisdiction, where all relevant recipients benefit from a class action when filed, class actions within the UK require investors to file their actions individually in order to potentially benefit from a successful class action. Such actions are therefore much less prevalent.

The Committee will recall a current class action relating to the alleged actions of Royal Bank of Scotland (RBS) where, it is argued, investors suffered losses in respect of a subsequent Rights Issue in 2008.

Confirmation has now been received from the UK lawyers arranging the class action that Lancashire County Pension Fund has now been added as a claimant to the claim against RBS.

Consultations

N/A

Implications:

It is a key component of good governance that the Fund is an engaged and responsible investor complying with the Stewardship Code.

Well run responsible companies are more likely to be successful and less likely to suffer from unexpected scandals.

Risk management

The promotion of good responsible corporate governance in the companies the Fund is invested in reduces the risk of unexpected losses arising as a result of poor over-sight and lack of independence.

Involvement in a non-US class action may result in losses incurred being recovered for the Fund, but should a case be lost then the Fund may incur related costs which may not be known with certainty at the time of filing. Applying for lead plaintiff status in the US may incur significant officer time and resources in bringing a potential case to fruition.

Should the claimants in the litigation against RBS fail, then it is possible that LCPF faces having to make a contribution towards RBS costs notwithstanding the insurance in place. The amount of any shortfall following an insurance settlement and the LCPF contribution thereto is impossible to quantify at this stage.

Furthermore, if successful the LCPF will be required to hand over a proportion of any sum recovered to the funder and claimant solicitors.

Local Government (Access to Information) Act 1985
List of Background Papers
N/A

LANCASHIRE QUARTERLY VOTING REPORT

OVERVIEW

1. The Pension Fund received voting recommendations for **535** resolutions at **35** meetings in the quarter ended **2014-03-31**.
2. The Pension Fund supported **314** of the resolution (**58.69%**).
3. The Pension Fund voted against on **139** occasions (**25.98%**).
4. The Pension Fund abstained on **47** occasions (**8.79%**).
5. There were **17** non-voting agenda items (**3.18%**).
6. There were **17** withheld agenda items (**3.18%**).
7. There were **0** not supported agenda items (**0.0%**).

APPENDIX A

TABLE 1: GEOGRAPHIC VOTING OVERVIEW

Geographic Region	Meeting	Resolutions	For	Oppose	Abstain	Withheld	Say When on Pay	Non-Voting
SOUTH AND CENTRAL AMERICA	1	3	2	1	0	0	0	0
REST OF THE WORLD	0	0	0	0	0	0	0	0
ASIA	3	13	1	0	12	0	0	0
NORTH AMERICA	18	253	146	82	7	17	0	0
UK	4	41	36	2	3	0	0	0
EU	7	184	91	51	25	0	0	17
JAPAN	2	41	38	3	0	0	0	0

TABLE 2: ANALYSIS OF UK ALLSHARE VOTING RECOMMENDATIONS

Resolution Type	For	Percentage %	Abstain	Percentage %	Oppose	Percentage %	Total
Annual Reports	2	100.0	0	0.0	0	0.0	2
Remuneration Reports	1	50.0	0	0.0	1	50.0	2
Articles of Association	1	100.0	0	0.0	0	0.0	1
Auditors Appointment	0	0.0	2	100.0	0	0.0	2
Directors	15	100.0	0	0.0	0	0.0	15
Dividend	2	100.0	0	0.0	0	0.0	2
Executive Pay Scheme	0		0		0		0

APPENDIX A

TABLE 3: SIGNIFICANT OPPOSE VOTES

Company	Date	Type	Proposal	Recommendation	Oppose Percentage

TABLE 4: MEETINGS VOTE / NOT VOTED IN THE QUARTER

Company	Meeting Date	Type	Date Voted	Comment
SHAW COMMUNICATIONS INC-CL B	2014-01-14	AGM	Not Voted	Shares on loan at record date
CAPITOL FEDERAL FINANCIAL INC	2014-01-21	AGM	2014-01-07	Voted
WH SMITH PLC	2014-01-22	AGM	2014-01-10	Voted
INTUIT INC.	2014-01-23	AGM	2014-01-10	Voted
BECTON DICKINSON & CO	2014-01-28	AGM	2014-01-14	Voted
METRO INC -CL A	2014-01-28	AGM	2014-01-22	Voted
VERIZON COMMUNICATIONS INC	2014-01-28	EGM	2014-01-14	Voted
VODAFONE GROUP PLC	2014-01-28	EGM	2014-01-14	Voted
VODAFONE GROUP PLC	2014-01-28	COURT	2014-01-14	Voted
VISA INC	2014-01-29	AGM	2014-01-14	Voted
ACCENTURE PLC	2014-01-30	AGM	2014-01-21	Voted
AMDOCS LTD	2014-01-30	AGM	2014-01-22	Voted
DOLBY LABORATORIES INC	2014-02-04	AGM	2014-01-22	Voted
IMPERIAL TOBACCO GROUP PLC	2014-02-05	AGM	2014-01-22	Voted
TD AMERITRADE HOLDING CORP	2014-02-12	AGM	2014-01-27	Voted
NOVARTIS AG	2014-02-25	AGM	2014-02-10	Voted
DEERE & CO.	2014-02-26	AGM	2014-02-10	Voted

APPENDIX A

APPLIED MATERIALS INC	2014-03-04	AGM	2014-02-17	Voted
QUALCOMM INC.	2014-03-04	AGM	2014-02-18	Voted
ROCHE HOLDING AG	2014-03-04	AGM	Not Voted	Non Voting Shares.
TE CONNECTIVITY LTD	2014-03-04	AGM	2014-02-13	Voted
PT BANK NEGARA INDONESIA	2014-03-06	AGM	2014-02-21	Voted
FRANKLIN RESOURCES INC	2014-03-12	AGM	2014-02-24	Voted
SAMSUNG ELECTRONICS CO LTD	2014-03-14	AGM	Not Voted	Info Only
SCHINDLER HOLDING AG	2014-03-17	AGM	Not Voted	Participation certificate
WALT DISNEY CO.	2014-03-18	AGM	2014-03-06	Voted
JYSKE BANK	2014-03-19	AGM	2014-03-10	Voted
CARLSBERG AS	2014-03-20	AGM	2014-03-07	Voted
SK HYNIX	2014-03-21	AGM	Not Voted	Bought after record date
BM&F BOVESPA SA	2014-03-24	AGM	2014-03-14	Voted
ORION CORP	2014-03-25	AGM	2014-03-13	Voted
YAMAHA MOTOR CO LTD	2014-03-25	AGM	2014-03-11	Voted
MCCORMICK & CO	2014-03-26	AGM	Not Voted	Non-voting shares held
SVENSKA HANDELSBANKEN	2014-03-26	AGM	2014-03-13	Voted
CANON INC	2014-03-28	AGM	2014-03-17	Voted

TABLE 5: GEOGRAPHICAL COUNT OF ALL SUPPORTED MEETINGS

SOUTH AND CENTRAL AMERICA			
Meetings	Count All For	AGM	EGM
1	0	0	0
REST OF THE WORLD			
Meetings	Count All For	AGM	EGM
0	0	0	0
ASIA			
Meetings	Count All For	AGM	EGM
3	0	0	0
NORTH AMERICA			
Meetings	Count All For	AGM	EGM
18	0	0	0
UK			
Meetings	Count All For	AGM	EGM
4	1	0	1
EU			
Meetings	Count All For	AGM	EGM
7	0	0	0
JAPAN			
Meetings	Count All For	AGM	EGM
2	1	1	0

CLIENT VOTE CHANGES

There were no vote changes during the quarter

UK

Local Authority Pension Fund Forum acts on Diversity

The Boards of FTSE companies are facing further pressure for reform after the Local Authorities Pension Fund Forum (LAPFF) announced it will take board diversity into account in any AGM voting recommendations it may make to member funds during the upcoming AGM season. The Forum will directly raise concerns where there is insufficient indication that the company has taken board diversity into consideration.

'In 2014, LAPFF will review FTSE 100 company disclosure, and based on individual company circumstances will consider recommending that its members vote against the election of the Chairman of the Nomination Committee if there are no women on the board. Where there are less than 25% of women on the board, the Forum will consider recommending that members abstain on the election of the Chairman of the Nomination Committee.' Forum Chair Councillor Keiran Quinn said.

LAPFF has also endorsed the October 2013 decision by high profile UK fund manager Legal & General Investment Management (LGIM) who have announced that from 2015 it would vote against the chairman or the chairman of the nominations committee if they have not installed any women on the board, or if aspirational targets have not been set, or if disclosure about gender balance is inadequate.

A February 2013 analysis undertaken by PIRC reveals that to reach the 25% Davies target for the start of 2015 FTSE 350 boards must double the 2013 rate of increase of female representation to around 5.8% and make over 4 new appointments each month in aggregate until January 2015.

The Professional Boards Forum 'Boardwatch' calculates a minimum of 51 more female directors are needed to meet the Davies target.

Attention is also being focussed on female representation on executive committees.

The Dec 2013 Cracking the Code Report research prepared for the 30% Club, of which LAPFF is a member, found that a man who starts his career with a FTSE 100 company is four and-a-half times more likely to reach the executive committee than his female counterpart.

Progress is also slow in the FTSE 250 according to the latest study by the Cranfield University School of Management 'Women on Boards' report issued in November 2013. They found the proportion of women on 250 executive committees had fallen from 17.2% in 2010 to 15.3% in 2013.

LAPFF coordinates corporate governance and engagement activities for UK public authority funds holding over £120b FUM.

Slowdown after several years of increases reflects post crisis realignment and more scrutiny on remuneration disparities between employees and executives.

Price Waterhouse Coopers have released their latest fee survey for FTSE 350 companies, helpfully differentiating between top 100, 250 and SMCs. The report notes a levelling off in fees for FTSE 100 companies and an increase in FTSE 250 remuneration. The median base fee level reported for a FTSE100 chair is £361,000 in 2013 up from the 2012 figure of £360,000. For FTSE100 NEDs the median base fee was £61,000 in 2013, a slight drop from 2012 where the median was £64,000. This follows five years of increases for both FTSE100 chairmen and non-executive directors from a 2009 base of £300,000 and £55,000, respectively. FTSE 250 companies have continued a steady rise over the same period.

One change that did draw attention was the 140% increase in FTSE 100 remuneration committee fees in the last five years, from £5,000 to £12,000 with the fee for chairing the committee now hovering at around £20,000, similar to that of the Audit committee chair.

US

Who gets the corporate millions is a governance question that won't go away.

A group of US Senators and Congressmen have written to SEC Chair Mary Jo White asking the regulator to require the disclosure of political donations by publicly traded US corporations. The intervention has come following the SEC decision to quietly drop consideration of the matter from its list of 2014 priorities despite signalling a year ago some possible action around the issue.
Pressure for reform to provide transparency has grown since the 2010 Supreme Court decision in 'Citizens United' sparked renewed concerns within the US political system over ability for corporations to donate funds direct to political campaigns without disclosure to shareholders or public transparency.
Business lobbies and trade associations spend tens of millions in the regular congressional election campaigns and again in the four yearly presidential elections.
Good governance principles would require at a minimum the ability of shareholders to see who benefits from such largesse. Democracy would benefit from voters knowing the same.

Europe:

EU Shareholder Rights Directive amendments released

The European Commission this week issued draft amendments to the Shareholder Rights Directive. The draft proposals have five specific objectives 1) To increase the level and quality of engagement by asset owners and managers 2) To improve the balance of directors pay with performance 3) to improve transparency and oversight of related party transactions 4) to ensure reliability and quality of advice by proxy advisors and 5) to facilitate the transmission of cross border information across the investment chain in particular through shareholder identification.

On a comply or explain basis institutional investors and asset managers who have not equipped themselves with an engagement policy will not only be required to develop a policy but to publicly disclose the policy , how it was implemented and the results of implementing the policy.

If the draft proposals are carried through the market for engagement services looks set to become much more transparent. Institutional investors will be expected to disclose publicly the extent to which they incentivise their asset managers to engage with companies. Increased competition in this field and transparency around who the players are in this market may be to the benefit of asset owners who will start to discover how much engagement bang they get for their engagement buck.

The forward looking three yearly approval of directors' remuneration policy and the backward looking annual approval of the remuneration report will become EU wide voting rights. These will be new rights in several EU markets. The new rights will be supported by new disclosure requirements. Amongst the most eye-catching are the proposals that companies disclose the maximum that may be awarded together with relevant performance criteria and the envisaged ratio of average directors pay to average full time employee pay.

Say on pay is not the only new voting right proposed. Shareholders are to be given the right to approve any related party transaction representing more than 5% of assets or other transaction with the potential for significant impact on profits or turnover. New disclosure requirements apply to RPTs between 1% and 5% of asset value. Under the proposals companies will not be able to avoid seeking shareholder approval by repeatedly conducting transactions at a level below the 5% threshold with the same party, for example a controlling shareholder. Such transactions must be aggregated on an annual basis under the proposals and a vote held on any transaction after the 5% threshold is passed.

Following on from the ESMA report on the proxy voting advisory market the Draft Directive imposes challenging disclosure requirements on proxy agencies. Methodologies, models, staff numbers information sources and the nature of dialogue with companies must all be disclosed.

The proposals also seek to put an end to the secrecy which can currently surround the identity of a company's shareholders. Rights similar to those in s793 of the UK Companies Act would apply with a company able to obtain details of those named on its register but also the identity of the shareholders sitting behind those on the register where this is an intermediary.

The proposals on information rights also heralds the long sought introduction of electronic vote confirmation an enhancement that has eluded several market led initiatives over the last 20 years.

As ever both the devil and the delight will be in the detail and as the proposals have yet to be adopted by Council or Parliament both are some way off.

Roche Holdings

Swiss pay reform fight moves to the AGM trenches

You know the old saying – you wait for ages for a vote on executive pay to come along then 5 turn up at the same time. This is a fitting description of the upcoming AGM ballot for Swiss pharma Roche where shareholders are being asked to vote on five separate pay related resolutions. The votes on pay arise from the implementation of Switzerland's new law Verordnung gegen übermässige Vergütungen bei börsenkotierten Aktiengesellschaften (Ordinance against excessive compensation in listed corporations or VeguV for short). Under the VeguV companies have some discretion over the exact nature of what they should seek approval for but they are required to set out the details of the vote in their articles of association.
As a result Roche is seeking approval for
1) Binding approval of changes to the articles to give effect to the new ordinance
2) Binding approval of the total amount of future remuneration to the board
3) Binding approval of total amount of future remuneration for the Corporate Executive Committee
4) Binding retrospective approval for bonuses to the Corporate Executive Committee and Chairman
5) Advisory approval of the remuneration report which contains forward and backwards disclosures for both executive committee and board.
Big pharma doesn't come much bigger than Roche, the world's largest biotech company and the third largest EU company by market value so the way it has approached the new regulations will be important in setting the tone for other Swiss issuers.
On the face of it binding approval for forward and backward pay for board and executive committee may seem like full and proper accountability. Look a little closer and it becomes clear that the disclosure which supports the new votes is as solid as a piece of Swiss cheese. Although shareholders now have a binding vote on total pay at Swiss companies caution still needs to be exercised. At Roche the amount of bonus to be approved doesn't show the value of shares awarded at market price but instead values awards on the assumption they are worth less if an executive is obliged to hold on to them.
The Swiss fight to reform excessive remuneration took a step forward with the passage of VeguV despite a vigorous corporate campaign to water down its effectiveness. Shareholders who support improved governance may now have to battle it out AGM by AGM to bring about meaningful transparency and disclosure.

Global

Reforms to corporate structures, disclosure and shareholder rights reflect a growing regional trend for improved governance

The Securities and Exchange Board of India (SEBI) has announced a raft of governance changes to listed companies set to apply from October this year.

The proposed changes to the Listing Agreement are consistent, and in some cases strengthen, provisions of the new companies' law ratified last year and make it mandatory for boards to have at least one female appointee, places restrictions on multiple directorships and imposes additional disclosure on executive remuneration.

Other changes include strengthening definitions and oversight of related party transactions and the role of audit committees in overseeing governance.

The thrust of the changes continues a drive to expand shareholder rights and transparency and improve overall governance within India's equity markets which have been the source of continued dissatisfaction over sharp corporate practices. The new measures have been broadly welcomed by observers though some doubts remain over the ultimate efficacy of measures to restrict the number of investment layers and ensure transparency around the ultimate beneficiary.

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QUARTERLY ENGAGEMENT REPORT

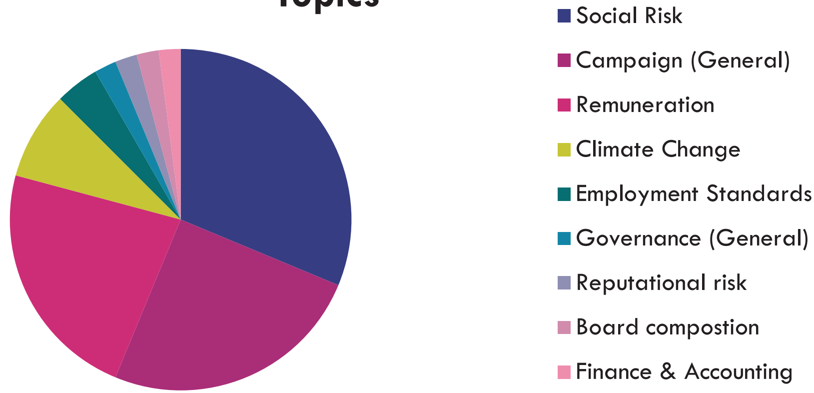
JANUARY TO MARCH 2014

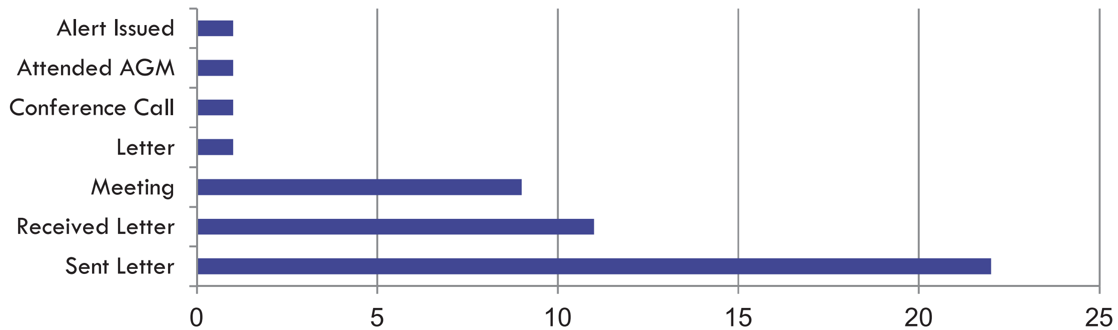
Local Authority Pension Fund Forum

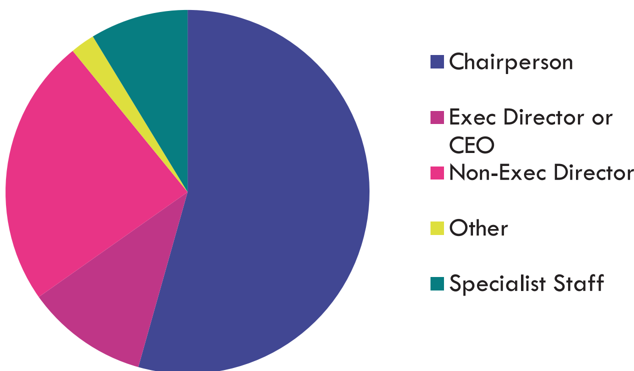
LAPFF exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders whilst promoting social responsibility and corporate governance at the companies in which they invest. Formed in 1990, the Forum brings together a diverse range of local authority pension funds in the UK with combined assets of over £125 billion.

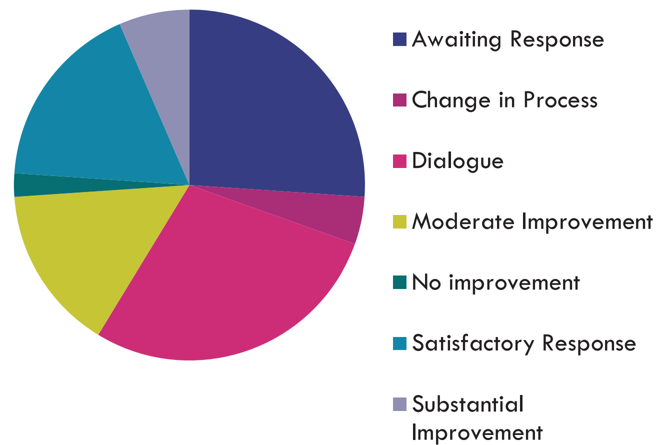
ENGAGEMENT SUMMARY

JANUARY TO MARCH 2014









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ACHIEVEMENTS

- **UK Listing Authority** amends listing rules for independent directors in majority controlled companies to only be elected by non-majority members, in line with LAPFF position set out in its response to the 2012 consultation on the issue.
- Attended **Lonmin** AGM as part of ongoing engagement around labour relations, and pressed board members for more detail on the company's 'five-point plan'.
- Held meetings with **easyJet, G4S** and **Afren** remuneration committee chairs regarding pay complexity and overall pay awards. Met with **BT** to discuss the company's approach to remuneration.
- Following collaborative engagement on board diversity, **London Stock Exchange** appointed two women to the board.
- Met with the **Nestlé SA** chair, with **Roche Holding** and **Jardine Matheson,** prompted by the Forum's holdings-based approach. Pay was a central focus of these meetings.
- Supported **Wilmar** in its commitment to sustainable palm oil sourcing subsequent to collaborative letters to US companies on the sustainability of their supplies. **Kelloggs** also announced a policy for sourcing sustainable palm oil following engagement.
- Responded with the investor coalition to the second **FRC** consultation on Sharman and Going Concern, to support the original Sharman proposals, not the FRC amendments. Given the opposition the FRC is now going to have to consult for the third time.
- Provided a response to the **Law Commision** fiduciary duty consultation presenting a LGPS perspective on key issues of stewardship, short termism and beneficiaries' interests.

THE FORUM IN THE NEWS

LAPFF leads high profile demands to return to 'prudent' accounting regulations.
The Telegraph and again The Telegraph

UK pension funds weigh in on board re-election threat over female director targets
Responsible Investor

LAPFF challenges bus operator over human rights
Investment and Pensions Europe, Professional Pensions, Market Watch

Investors demand scalp of Barclays Bonus-setting chief
The Times, Bloomberg

Early blow for 'say on pay' guidelines
Financial Times

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COMPANY ENGAGEMENT

LEADERSHIP ON KEY CAMPAIGNS

The Forum has progressed its engagement on 'blacklisting' by writing to a further six construction companies supporting the development and implementation of a compensation scheme for any individuals affected by blacklisting. LAPFF requested that the companies work constructively with relevant trades unions and others representing the victims of blacklisting in order to ensure that the scheme is implemented quickly and in a way that is acceptable to those affected. Of the companies contacted, **Carillion, Amec** and **Costain** responded, giving further company specific information. Two companies expressed support for a code of conduct aimed at preventing any repetition of similar practices in future.

Together with some members of the Investor Group of the 30% club, LAPFF had written to a number of companies on board gender diversity in late 2013. A meeting had been set up with the chairman of the **London Stock Exchange** as it had no women on its board. However, shortly prior to the meeting, the company announced the appointment of Sherry Coutu and Joanna Shields to the board. This leaves Glencore Xstrata as the sole FTSE 100 company with no female board directors.

PROMOTING GOOD GOVERNANCE

Holdings Based Engagement

In line with an increasing focus on holdings based engagement, analysis was undertaken on governance and corporate responsibility concerns at those European and Asian companies most widely held by member funds. Letters were sent to six companies and meetings held with Roche Holding and Jardine Mattheson, and LAPFF attended a roundtable with the Nestle chairman.

All three meetings sought to establish a positive, ongoing dialogue and understand each company's approach to managing shareholder concerns over governance and company specific issues. Nestlé and Roche Holding are both Swiss companies, for whom the mandatory pay vote was a key concern and thus was a core component of discussion.

The conversation with **Roche Holding** was a first and explored the possibility of strengthening minority shareholder rights as descendants of the founding families own 45% of issued share cap and another Swiss pharma company owns a further one third of shares. On remuneration,

further clarity was sought on clawback and introductory payments. LAPFF also sought a better understanding of the company's approach to patents and their application in developing countries.

The Forum previously met with **Nestlé** in 2011, to discuss a range of governance issues including compensation and succession planning. The meeting this quarter was in the form of a chairman's round-table. The chairman set the agenda around the new requirement for a binding vote on pay in Switzerland, the 'Minder' initiative. One concern raised was that the framework for informing variable pay is opaque and makes it difficult for investors to assess whether amounts paid were in line with performance expectations.

The meeting with **Jardine Mattheson** was a first for LAPFF. The Keswick family is a controlling shareholder of this Hong-Kong based conglomerate, with three family members holding board positions as chair, managing director and deputy managing director. LAPFF explored the importance of independent directors and the company's recent decision to withdraw from a premium listing in London.

Executive Pay

Meetings continued with companies to solicit feedback to LAPFF's Expectations for Executive Pay document. A meeting with Patricia Hewitt, the remuneration chair at **BT Group** was prompted by the LAPFF's positive viewing of the company's decision to reduce the short-term bonus opportunity for the Chief Executive of BT Retail. The company places greater emphasis on variable pay in relation to base pay than the Forum promotes. However, in doing so this does appear consistent with seeking to ensure widespread financial participation in the performance of the firm. The focus on variable pay also helps ensure that pay awards are felt to be fair throughout the Company.

Other company meetings aimed to focus on complexity in pay practices. In the Forum's view excessive complexity can confuse both executives and shareholders and obscure the relationship between executives' everyday actions and the expected outcome of better shareholder return.

easyJet had been identified as a company that had received significant dissent over its pay practices at its 2013 AGM and had been making its long-term incentive plan (LTIP) metric more complicated over time. The company regularly consulted with institutional shareholders and moved from a return on equity to a return on capital employed metric. After further consultation with shareholders, leases were then included in this measure. On further consultation a measure of relative total shareholder return was added. It was clear that the company had been proactively consulting with its institutional investors to ensure pay practices

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were in line with their expectations. Prior to the 2014 AGM, the Forum issued a voting alert recommending members approve the remuneration report.

The Forum also had discussions over remuneration disclosure with **G4S** in particular for the 2012 period. The company clarified that the only long-term award that accrued for that period was under the TSR metric and that disclosure could be clearer as regarded adjustments to incentive scheme metrics in future. G4S recognises the down-side of complexity in remuneration scheme metrics but they have to balance this against the benefits of aligning the scheme with the company's strategic objectives.

As a company that only listed in 2005, **Afren** has grown rapidly and entered the FTSE 250 in 2010. LAPFF has met with company representatives several times since 2011 to discuss its remuneration practices. The company has had high oppose votes in four of the last five years including its pay vote being defeated at the 2013 AGM. A major issue previously had been the ability to award special bonuses and this provision has been removed. At a follow-up meeting, the chair of the remuneration committee was pressed on further measures to ensure that shareholders will view remuneration arrangements as appropriate in the binding vote on pay at the 2014 AGM.

Reliable Accounts

LAPFF had, under the former LAPFF Chair, met with Baroness Hogg Chair of the Financial Reporting Council (FRC) regarding problems with International Financial Reporting Standards (IFRS) and the implications for the accounts (and the audits of banks). The FRC public position remained positive towards IFRS despites strong criticism in the UK and EU Parliaments.

LAPFF also engaged with Sir Win Bischoff (outgoing chair of Lloyds Banking Group) who had been publicly critical of IFRS. Sir Win is now the incoming chair of the FRC from 1 May 2014 which LAPFF supports. (LAPFF with the investor coalition had written to Vince Cable with the view that the new FRC Chair should not be from one of the Big 4 accounting firms).

An Evening Standard article dated 28 February 2014 is an interview with the outgoing Baroness Hogg. The headline is "the numbers must add up next time, warns the Footsie's first lady". In it she also expresses concern about the effectiveness of bank auditors and the delay in the FRC investigating accounting/audit failures.

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MANAGING ENVIRONMENTAL RISK

Palm oil

Following its engagement with a number of US companies on sustainable palm oil, LAPFF signed an investor statement of support for **Wilmar**'s recently announced commitment to eliminate deforestation, peatland development and human rights violations from its palm oil supply chain. Wilmar is the world's largest palm oil trader, controlling 45% of the global palm oil trade and the aim of the statement was to ensure that the company was appropriately recognised for their groundbreaking commitment.

Wilmar and Kelloggs commit to eliminate deforestation from their palm oil supply chains

The Forum had already written to **Kelloggs** on this same concern, in collaboration with other investors in late 2013. In February, Kellogg's announced a policy to only purchase sustainable palm oil with a target of end 2015 for compliance.

Energy and Environmental Risk

Continuing its engagement with listed companies on 'fracking' activities, LAPFF is participating in a collaborative initiative coordinated through the PRI with a number of asset managers and asset owners. The Forum has co-signed letters to six companies in the oil and gas sector requesting meetings aimed at ensuring a proper understanding of the risks involved and to encourage best practice to minimise these risks.

TARGETING SOCIAL ISSUES

Employment Standards

Following correspondence in late 2013 with **Lonmin** regarding media coverage of actions during the 2012 Marikana mine incident, LAPFF attended the company's AGM for the second year running in January. Over the year, there have been a number of board changes, including the appointment of the new chief executive, Ben Megara.

The Chair and Chief executive gave useful updates on progress on the company's 'five-point plan' and wider initiatives. The company has recovered well from the impact of the previous wildcat strike, but is now being badly hit by the recently started protected strike by the Association of Mineworkers and Construction Union (AMCU). Cllr Brayshaw pressed for as much detail as possible on plan projects, timescales and metrics, in particular on reforming shift patterns, housing provision, on the

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local/migrant labour balance and on other points in the plan. He indicated LAPFF would continue positive dialogue with on overall progress at its various South African operations.

Further changes have emerged at **Deutsche Post** following engagement by LAPFF, unions and other investors. These have been negotiated through a settlement mediated by the German National Contact Point for the OECD Guidelines for Multinational Enterprises and include assessments of industrial relations with affiliate unions in India and Columbia.

CONSULTATIONS & PUBLIC POLICY

ENGAGING WITH POLICY-MAKERS

LAPFF remains closely involved in shaping the debate around the proposed restructuring of the Local Government Pension Scheme. The LAPFF chair and vice-chair are active members of the **LGPS Advisory Board Investment and Engagement Subcommittee**. The Forum submitted a report to the Subcommittee on 'Local Authority Pension Funds and Active Stewardship' setting out how LAPFF operates to bring together funds to engage collectively and effectively.

LAPFF has been concerned about the governance of both the process of setting accounting standards and of the Financial Reporting Council. One aspect of concern is the dominant representation of the Big 4 Accounting firms, their immediate alumni, investment banking interest and sell-side analysts. LAPFF and the investor coalition have not engaged directly with the IASB because of these governance concerns, instead have engaged with accountable parties aiming to make the IASB accountable.

During January and February, the Economic Affairs Committee of the EU Parliament followed up on Daily Telegraph reports of serious compliance issues with the IASB being up to seven years in arrears with Companies House filings. The matter has been pursued by a cross party coalition of MEPs including UK Lib Dem Sharon Bowles MEP and UK Conservative leader Syed Kamall MEP, plus the Greens and Socialists. The IASB issued a public rebuttal which was then proven wrong.

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CONSULTATION RESPONSES

In response to a request from the Department for Business, Innovation & Skills (BIS) and the Department for Work and Pensions (DWP) the **Law Commission** issued a consultation on how fiduciary duties currently apply to those working in financial markets. This asked questions to flesh out views on how far pension duties require trustees to maximise financial return over a short time scale, and how far trustees can consider other factors, such as environmental and social impact. LAPFF's response presented a LGPS perspective on key issues of stewardship, short termism and beneficiaries' interests.

A response was also provided to the **Financial Reporting Council's (FRC)** second consultation on Risk management, Internal Control and the Going Concern Basis of Accounting. In its response, LAPFF strongly supported the original Sharman proposals not the amendments proposed by the FRC, pointing out that recent FRC statements on the quality of audits at UK banks would suggest that directors and auditors should be undertaking their basic task properly as opposed to reviewing a list of generalised risks. The FRC is now in a position of having to re-consult, i.e. for a third time.

All LAPFF consultation responses can be viewed at: http://www.lapfforum.org/consultations.

NETWORKS & EVENTS

Representatives of LAPFF regularly attend conferences and events on behalf of members. A list of recent events attended is as follows:

- **ICGN - PRI meeting** – board composition and director elections
- **PRI Fixed Income Event** – hosted by AXA Investment Managers
- **Centre for the Study of Financial Innovation** – round table on carbon bonds

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COMPANY PROGRESS REPORT

Company	Topics	Outcome
Afren	Remuneration	Moderate Improvement
AIA Group	Holdings Based Engagement	Awaiting Response
Amec	Blacklisting	Satisfactory Response
Balfour Beatty	Blacklisting	Awaiting Response
BT Group	Remuneration	Satisfactory Response
Carillion	Blacklisting	Dialogue
Costain	Blacklisting	Satisfactory Response
Deutsche Post	Social Risk	Substantial Improvement
easyJet	Remuneration	Moderate Improvement
Essar Energy	Governance (delisting)	Awaiting Response
ExxonMobil	Climate Change	Change in Process
G4S	Remuneration	Dialogue
Golden Agri	Sustainable Palm Oil	Dialogue
Hormel Foods	Sustainable Palm Oil	Satisfactory Response
Jardine Matheson	Holdings Based Engagement	Dialogue
London Stock Exchange	Board composition	Substantial Improvement
Lonmin	Employment Standards, Social	Change in Process
N Brown	Social Risk	Satisfactory Response
Nestle	Holdings Based Engagement	Dialogue
Novartis	Holdings Based Engagement	Dialogue
Roche Holding AG	Holdings Based Engagement	Dialogue
RSA	Finance & Accounting	Awaiting Response
Samsung	Holdings Based Engagement	Awaiting Response
Skanska AB	Blacklisting	Awaiting Response
Svenska Handelsbank	Remuneration	Awaiting Response
Trinity Mirror	Reputational risk, Social Risk	Dialogue
Vinci	Social Risk	Dialogue

Companies LAPFF has not previously engaged with individually are indicated in bold. ‘Awaiting response’ indicates a letter was sent during the period but a written response was not received.

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The Local Authority Pension Fund Forum was established in 1991 and is a voluntary association of local authority pension funds based in the UK. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which its members invest. The Forum's members currently have combined assets of over £125 billion.

Report prepared by PIRC Ltd. for the Local Authority Pension Fund Forum

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Aberdeen City Council
Avon Pension Fund
Barking and Dagenham LB
Bedfordshire Pension Fund
Camden LB
Cheshire Pension Fund
City of London Corporation
Clwyd Pension Fund
Croydon LB
Cumbria Pension Scheme
Derbyshire CC
Devon CC
Dorset County Pension Fund
Dyfed Pension Fund
Ealing LB
East Riding of Yorkshire Council
East Sussex Pension Fund
Enfield
Falkirk Council
Greater Gwent Fund
Greater Manchester Pension Fund
Greenwich Pension Fund
Gwynedd Pension Fund
Hackney LB
Hampshire Pension Fund
Haringey LB
Harrow LB
Hounslow LB
Islington LB
Lancashire County Pension Fund
Lambeth LB
Lewisham LB
Lincolnshire CC
London Pension Fund Authority
Lothian Pension Fund
Merseyside Pension Fund
Newham LB
Norfolk Pension Fund
North East Scotland Pension Fund
North Yorkshire CC Pension Fund
Northamptonshire CC
NILGOSC
Nottinghamshire CC
Rhondda Cynon Taf
Shropshire Council
Somerset CC
South Yorkshire Integrated Transport Authority
South Yorkshire Pensions Authority
Southwark LB
Staffordshire Pension Fund
Surrey CC
Teesside Pension Fund
Tower Hamlets LB
Tyne and Wear Pension Fund
Waltham Forest LB
Warwickshire Pension Fund
West Midlands ITA Pension Fund
West Midlands Pension Fund
West Yorkshire Pension Fund
Wiltshire CC
Worcestershire CC

Pension Fund Committee
Meeting to be held on 6 June 2014

Electoral Division affected: All

Internal audit annual report 2013/14, including the audit plan 2014/15
(Appendix 'A' refers)

Contact for further information:
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Executive Summary

A copy of the internal audit annual report for the Lancashire County Pension Fund is attached at Appendix 'A'. Based on the internal audit work undertaken during the year we are able to provide substantial assurance over the internal control environment for the pension fund and pension administration.

The report also sets out the plan of work to be undertaken by the county council's internal audit service for this financial year in respect of the pension fund. The plan amounts to a total planned resource of 85 days.

Recommendation

The Committee is asked:

1. to consider and note the annual report.

2. to consider and approve the audit plan for 2014/15.

Background and Advice

The Public Sector Internal Audit Standards require the Internal Audit Service to provide a written report to those charged with governance which includes an opinion on the overall adequacy and effectiveness of the organisation's control environment. This report presents our opinion based upon the work we have performed during 2013/14 for the Lancashire Pension Fund.

The audit plan is intended to provide assurance to the Pension Fund Committee and to the treasurer to the fund who is required to sign an Annual Governance Statement (AGS), incorporating a statement of internal control.

Lancashire County Council

Consultations

In deriving the audit plan the internal audit team has:

- Discussed with senior management the risks and related controls associated with the pension fund and;

- Made its own assessment of the risks facing the pension fund.

The information derived from these consultations has been incorporated into the audit plan.

Implications:

Not applicable

Risk management

This report supports the Pension Fund Committee in undertaking its role which includes providing independent oversight of the adequacy of the pension fund's governance, risk management and internal control framework.

Local Government (Access to Information) Act 1985
List of Background Papers

Paper	Date	Contact/Directorate/Tel
The Public Sector Internal Audit Standards	2013	Rachel Tanner County Treasurer's Directorate X 34904

Reason for inclusion in Part II, if appropriate:

N/A

Appendix 'A'

Lancashire County Council: Pension Fund

Internal Audit Service

Annual report for the year ended 31 March 2014, including the proposed internal audit plan 2014/15

Contents

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1 Introduction

1.1 Internal Audit is an assurance function that primarily provides an independent and objective opinion on the adequacy of the organisation's control environment. The Public Sector Internal Audit Standards require the chief internal auditor to provide a written report to those charged with governance, timed to support the Annual Governance Statement, which includes an opinion on the overall adequacy and effectiveness of the organisation's governance arrangements, including the control environment. This report presents our opinion based upon the work we have performed.

1.2 This report covers the period 1 April 2013 to 31 March 2014.

Acknowledgements

1.3 We are grateful for the assistance that has been provided to us by staff in the County Treasurer's Directorate and Your Pensions Service.

2 Assessment of internal controls

Overall opinion

2.1 Based on the internal audit work undertaken during the year we are able to provide **substantial** assurance over the internal control environment for the pension fund and pension administration.

2.2 It is our opinion that there is a generally sound system of internal control which is adequately designed and controls are being consistently applied in the majority of areas reviewed, although there are some areas where control needs to be strengthened.

2.3 Management responses to the findings from our work have been positive and indicate that action has or will be taken where issues have been identified. Our detailed findings identify good areas of effective control, raising only a small number of control issues which need to be addressed.

Key issues and themes arising during the period

2.4 The findings of the individual reviews are briefly set out in the following paragraphs.

2.5 We are able to provide substantial assurance over the pension administration procedures operated during the year which included the controls relating to auto-enrolment. Employers are required by law to enrol all workers, who meet certain criteria, into the workplace pension

scheme. The review also considered the adequacy and effectiveness of the arrangements operated for the following:

- payment of pensions;
- retirement calculations;
- death grant calculations;
- employee contributions to the scheme and
- transfers into and out of the scheme.

We have made one recommendation relating to evidencing the checks undertaken on the audit logs recording changes made within the pension administration system.

2.6 In addition, we reviewed separately the processes and procedures for administering the receipt of employer contributions to the pension fund and are able to provide substantial assurance over the arrangements operated. We have made one recommendation to ensure the prompt reconciliation of the pension administration system and the general ledger.

2.7 In relation to pension fund assets and investments our work has encompassed three reviews consisting of the investment strategy, the general ledger and third party assurance reports produced for a sample of the investment managers.

2.8 Our review of the investment strategy focused on ensuring that arrangements for investing funds are in accordance with the approved investment strategy and focussed specifically on the role of the Investment Panel in making individual investment decisions during the year rather than simply placing funds with investment managers.

2.9 In particular we reviewed that :

- The composition of the Investment Panel is consistent with the agreed terms of reference;
- Investment opportunities are presented to the Panel and discussed in detail;
- A detailed due diligence report is compiled for each investment opportunity, signed off by the deputy county treasurer and debated by the Panel;
- Only investment opportunities that receive unanimous support of the investment panel professionals are approved by the treasurer to the fund; and
- Decisions to invest, and the reasons for doing so, are clearly presented to the Pension Fund Committee.

2.10 We are able to provide full assurance over the systems operated. There were no areas identified that would have a major impact on the achievement of the pension fund's objectives, and the controls were consistently applied.

2.11 We have reviewed the accounting arrangements operated through the pension fund general ledger and have provided a substantial assurance opinion, indicating that the procedures are adequately designed and operating effectively in the majority of areas reviewed.

2.12 We have made two recommendations to further improve the control arrangements by ensuring that consistent information is included on accounting journals and ensuring changes to access permissions are undertaken promptly for employees who have either left the county council or changed their role.

2.13 Our review of the third party assurance reports produced for a sample fund manager's systems enabled us to conclude that reliance can be placed on the control statements which did not identify any significant control issues.

2.14 The re-tendering of the fund's property management contract has been delayed due to other priorities during the year; consequently we were not able to undertake the intended review of the procurement arrangements for this contract. We are proposing to include this review in the 2014/15 internal audit plan (Section 4).

Fraud/ special investigations

2.15 There were no days used in the investigation of suspected financial irregularities in relation to the pension fund.

National Fraud Initiative (NFI)

2.16 In addition to the planned audit reviews we have also undertaken work relating to the National Fraud Initiative (NFI). As part of the county council's duty to protect public funds, the Audit Commission requires all local authorities to participate in the NFI. This exercise has recently been undertaken on a six monthly basis, in order that any overpayments can be indentified and recovered at the earliest opportunity. One of the tests included relates to identifying pension claimants that may have died or may have additional employment affecting their pension.

2.17 The current NFI exercise identified 2,060 matches for Lancashire. Your Pension Service (YPS) has processed approximately 96 % of these matches to date and has not identified any overpayments. YPS is currently in the process of completing the investigation of the small number of remaining matches.

Implications for the Annual Governance Statement

2.18 On the basis of our work during 2013/14, we are aware of no internal control weakness that requires disclosure in the Annual Governance Statement.

3 Internal audit work undertaken

3.1 Work carried out during 2013/14 was in accordance with the audit plan presented and approved by the Pension Fund Committee in June 2013. Details of the assurance provided, and key issues identified for each of the areas covered are set out in the 'Summary of our Findings and Assurance' table attached at page 8. This shows that 71 days were spent on delivering the audit plan against planned audit activity of 85 days.

3.2 This work has been undertaken with liaison with the council's external auditors to minimise any duplication in planned coverage.

4 Internal audit plan 2014/15

4.1 The plan again focuses on two distinct areas which cover the governance and management of the pension fund's assets and pension administration. The audit reviews identified under each of these areas is explained in a little more detail below.

Pension Fund

4.2 We have included audit resources within the 2014/15 plan to ensure that there are adequate and effective arrangements in place to monitor the performance and continued appropriateness of the investments made. (20 days)

4.3 In line with best practise we will again provide assurance over the accounting arrangements for the pension fund. (10 days)

4.4 We are proposing to review the adequacy of the processes employed for the procurement of the property fund mandate which has been deferred from the 2013/14 internal audit plan. (10 days)

Pension administration

4.5 We propose to focus this year's work on testing the adequacy and effectiveness of the processes introduced since 1 April 2014 to reflect the significant changes required as part of the Local Government Pension Scheme 2014, in particular the change to a Care Average Revalued

Earnings (CARE) scheme. The allocation of days has been increased from previous years to reflect the requirement to document any new processes and the testing required to provide an appropriate level of assurance over this area. (40 days)

Follow Up

4.6 Audit resources have been identified to ensure that all reviews are followed up and our findings are re-assessed as the actions previously agreed with management are implemented. (2 days)

General Management

4.7 An allocation of 3 days has also been made to cover other management and tasks in support of the internal audit service to the pension fund:

- Attendance at meetings;
- Liaison with the Audit Commission; and
- Central reporting.

4.8 The proposed plan amounts to 85 days (85 days 2013/14).

5 Scope, responsibilities and assurance

5.1 Details of the scope of our work, and management's and internal audit's responsibilities regarding systems of risk management, internal control are explained in pages 8 and 9. This sets out the basis of our assessment and limitations on the assurance that we can provide.

Access to this report and responsibility to third parties

5.2 We have prepared this report solely for Lancashire County Council, and the Pension Fund Committee. As you are aware, this report forms part of a continuing dialogue between the Internal Audit Service, the Treasurer to the Fund, and the Pension Fund Committee. It is not therefore intended to include every matter that came to our attention during each internal audit review.

5.3 We acknowledge that this report may be made available to other parties, such as the external auditors. We accept no responsibility to any third party who may receive this report for any reliance that they may place on it and, in particular, we expect the external auditors to determine for themselves the extent to which they choose to utilise our work.

6 Summary of findings

Overall summary and assurance provided

6.1 We have set out in the table on page 7 below a brief summary of each review undertaken during this year. This sets out the planned and actual days we have spent on each review, and a summary of the assurance we have been able to provide in relation to each system or operational area of your business. The key issues/comments encapsulate the significant issues and areas where key recommendations were made. They reflect the findings at the time the work was carried out.

6.2 We have distilled the assurance into an assessment of the adequacy of each system, and its effectiveness in operation.

6.3 ***System adequacy***: We have defined a system as adequate if its design enables it to achieve its core control objectives which, if operating as intended, serve to manage its inherent risks.

6.4 ***System effectiveness***: We have defined a system as operating effectively if, after testing or other supporting evidence has been found, it is operating as intended.

6.5 It is therefore possible that a system would, if operated as intended, provide adequate control over its inherent risks, but that lapses in controls in practice leave the system exposed to risk.

6.6 It is also possible that a system may be inadequate in its design, but is nonetheless operating as intended, albeit with inbuilt weaknesses that mean that the control objectives cannot be met.

6.7 Ideally, a system will be adequately designed to achieve its control objectives, and operated effectively in practice.

6.8 The table below indicates briefly with simple ticks (✓) and crosses (x) our overall assessment of each system we have reviewed during the year and the assurance you may take from its operation in supporting effective internal control.

Summary of our findings and assurance

Review area	Audit days			Assurance		Key issues / Comments
	Planned	Actual	Variation	Adequacy	Effectiveness	
Audit Areas						
Investment strategy	20	15	(5)	✓	✓	The final report was issued in May 2014.
				Full assurance		
General ledger	10	10	0	✓	✓	The draft report was issued in May 2014.
				Substantial assurance		
Third party assurance reports	3	1	(2)	✓	✓	We noted that the expected key controls were in place for the sample reports reviewed and assurance was provided on them in the reports.
				Reliance can be placed on the assurance reports.		
Procurement arrangements - property fund mandate	10	1	(9)	-	-	The days relate to initial discussions and preparatory work. The retender of the property fund contract has been delayed due to other priorities during the year.
Pensions administration	30	32	2	✓	✓	The draft report was issued in May 2014.
				Substantial assurance		
Employer contributions	5	5	0	✓	✓	The final report was issued in May 2014.
				Substantial assurance		
Follow up	2	2	0	✓	✓	This related to the follow up of recommendations for the 2012/13 pension fund reviews. All recommendations had been implemented with the exception of one; ensuring that consistent information is included on all accounting journals (general ledger).
				Substantial assurance		
Planning and management	5	5	0	-	-	This time relates to the production of the annual plan and report, planning/ progress meetings and general advice.
Total Days	**85**	**71**	**(14)**			

Summary of our findings and assurance

1. Scope, responsibilities and assurance

Approach

1.1 In accordance with the Public Sector internal Audit Standards, the scope of internal audit encompasses all of the council's operations, resources and services including where they are provided by other organisations on their behalf.

Responsibilities of management and internal auditors

1.2 It is management's responsibility to maintain systems of risk management, internal control and governance. Internal audit is an element of the internal control framework assisting management in the effective discharge of its responsibilities and functions by examining and evaluating controls. Internal auditors cannot therefore be held responsible for internal control failures.

1.3 However, we have planned our work so that we have a reasonable expectation of detecting significant control weaknesses. We have reported all such weaknesses to you as they have become known to us, without undue delay, and have worked with you to develop proposals for remedial action.

1.4 Internal audit procedures alone do not guarantee that fraud will be detected. Accordingly, our examinations as internal auditors should not be relied upon solely to disclose fraud or other irregularities which may exist, unless we are requested to carry out a special investigation for such activities in a particular area.

1.5 Internal audit's role includes assessing the adequacy of the risk management processes, key internal control systems and corporate governance arrangements put in place by management and performing testing on a sample of transactions to ensure those controls were operating for the period under review.

Basis of our assessment

1.6 Our opinion on the adequacy of control arrangements is based upon the result of internal audit reviews undertaken during the period in accordance with the plan approved by the Pension Fund Committee. We have obtained sufficient, reliable and relevant evidence to support the recommendations that we have made.

Limitations to the scope of our work

1.7 No limitations have been placed on the scope or extent of the work we carried out during the year by the management or staff of the County Treasurer's Directorate or Your Pensions Service.

Limitations on the assurance that internal audit can provide

1.8 There are inherent limitations as to what can be achieved by internal control and consequently limitations to the conclusions that can be drawn from our work as internal auditors. These limitations include the possibility of faulty judgement in decision making, of breakdowns because of human error, of control activities being circumvented by the collusion of two or more people and of management overriding controls. Also there is no certainty that internal controls will continue to operate effectively in future periods or that the controls will be adequate to mitigate all significant risks which may arise in future.

1.9 Decisions made in designing internal controls inevitably involve the acceptance of some degree of risk. As the outcome of the operation of internal controls cannot be predicted with absolute assurance any assessment of internal control is judgmental.

Audit assurance levels

1.10 The assurance we can provide over any area of control falls into one of four categories as follows:

Full assurance: there is a sound system of internal control which is adequately designed to meet the service objectives and is effective in that controls are being consistently applied.

Substantial assurance: there is a generally sound system of internal control, adequately designed to meet the service objectives, and controls are generally being applied consistently. However some weakness in the design and/ or inconsistent application of controls put the achievement of particular objectives at risk.

Limited assurance: weaknesses in the design and/ or inconsistent application of controls put the achievement of the service's objectives at risk.

No assurance: weaknesses in control and/ or consistent non-compliance with controls could result/ has resulted in failure to achieve the service objectives.