

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)

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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.

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 accountability 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
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Reason for inclusion in Part II, if appropriate

N/A