DCLG-LGA call for evidence on the future structure of the LGPS: the NAPF's response

September 2013

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Executive Summary

The NAPF's response to this call for evidence is based on our belief that public service workers should have access to good quality, sustainable and affordable pensions. Larger pension schemes can benefit from greater efficiencies, through reduced operating costs and improved investment performance and a governance premium - they are more likely to be well run and better able to take advantage of investment opportunities.

The Local Government Pension Scheme (LGPS) faces unprecedented internal and external challenges such as the introduction of the new scheme in 2014, maturing funds and increasing scheme opt outs. This is creating greater pressure to invest in ways that realise returns while managing risks. The Government is right to facilitate an open debate about the case for schemes working together to drive further efficiencies.

In responding to this call for evidence the NAPF set a higher level principle to guide the debate: that the LGPS should provide good quality pensions that are sustainable and affordable for the taxpayer. We believe that this debate should not be solely focused on cost but also on driving better governance and administration. Underlying this overarching principle are the following key objectives. That further consolidation should:

- Drive greater efficiencies in both administration and investment expenses;
- Enable greater investment innovation; and
- Drive better and more consistent governance of LA funds.

We set out to provide an accurate assessment of whether the options being debated meet these objectives. Ultimately we have been unable to make this assessment. This is because of the lack of accurate and directly comparable data available about both the current scheme and the consolidation options. Any major transformation project requires investment both in terms of money and resource, something the LGPS has limited ability to deliver in the short-term given more immediate priorities.

Therefore, the NAPF recommends that:

- the LGPS Annual Report currently being developed by the Shadow Board enables the consistent and accurate collection of information about the operation of LA funds;
- a formal evaluation is undertaken of the cost savings from the National LGPS Framework, perhaps by the Shadow Board Value for Money Sub-Committee;
- the Government undertake a full cost and benefit analysis of the options for further reform, including the wider impacts of another major change on pensioners and the running of local government;
- the Government should enable existing consolidation projects by making the necessary legal changes that would allow funds who wish to undertake further consolidation to do so; and
- the Government considers the most appropriate method for transitioning to any new structure. This should prioritise the need to ensure funds are well run and able to continue the vital day job of providing pensions to millions of people.

About the NAPF

The National Association of Pension Funds is the leading voice of workplace pension provision in the UK. We represent 1,300 pension schemes from all parts of the economy and 400 businesses providing essential services to the pensions industry. We represent both public and private sector schemes, including over 70% of the Local Authority pension funds. Our members provide pensions for 16m people and collectively hold assets of around £900bn, making them major institutional investors. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

Introduction

1. The administrative structure of the Local Government Pension Scheme (LGPS) has remained largely unchanged since the mid-1970s when the 1972 Superannuation Act set out the basis of the modern scheme. Now, as then, the scheme in England and Wales is administered locally, for participating employers, through 89 regional pension funds.

2. However this administrative structure is probably the only thing that has remained constant during that time. The past four decades have seen constant changes to the eligibility criteria and the benefit structure, most recently with the move to the new CARE scheme as part of the Coalition Government's wider reform of public service pensions. The management of pension funds has also changed dramatically, in particular the development of ever-more sophisticated investment management techniques to help modern funds, amongst other things, to access new asset classes in a quest to realise returns whilst also managing risk.

3. The challenges the LGPS now faces have arguably never been greater. There are significant pressures with the introduction of the new scheme in 2014, the roll out of automatic enrolment, and the abolition of contracting out in 2016. All will have significant implications for scheme funding, design and administration. Wider societal and economic factors will continue to have a major impact with Local Authority (LA) funds struggling to navigate their way through an environment of low returns and historically low gilt yields. This is expected to cause significant increases to scheme deficits in the 2013 round of valuations, at a time when LA budgets are already under pressure and against a backdrop of rising longevity and ever increasing scheme liabilities.

4. LGPS funds are rapidly maturing. Our projections suggest that positive cash flows will quickly turn into negative cash flows over the next few years[1]. Meanwhile scheme members' affordability concerns are increasing scheme opt outs, putting further cash flow pressure on the scheme and sponsoring employers. This places much greater emphasis on the management of liabilities and risk and points to the need to hedge those liabilities and manage risk more effectively.

5. Given this challenging and ever-changing landscape it is important that LA funds are able to respond swiftly to these changes whilst continuing to deliver pension benefits to local government workers in a way that is affordable for taxpayers. Therefore the Government is right to facilitate an open debate about the case for funds working together to drive efficiency.

[1] Local Government Pensions Scheme 2013: investing in a changing world, NAPF, May 2013.

The costs of the current system

6. In order to assess whether the LGPS could be run more efficiently we must first understand what it currently costs to run and how this compares with its peers. At present the 89 administering authorities each manage their own investment and administration. In 2011/12 the LGPS as a whole paid out £7.5bn in benefits, up by 12% from 2010-11. Costs charged to the funds for fund management and administration totalled £468m on total assets under management (AUM) of £148bn at end March 2012[2]. This means the average annual costs are .32% of the AUM.

7. This average 'charge' is low when compared with the average annual management charge (AMC) of private sector schemes. The average AMC for DC schemes covered by the NAPF Annual Survey 2012 was 44bps[3]. For private sector DB schemes (DB schemes) it was 41bps[4]. These costs drop considerably when figures are weighted by size of fund: the average LA funds' AMC drops to 23bps and for DB schemes to 25bps. This suggests that whilst the current costs of the LGPS are low compared with private sector pensions, the larger DB schemes and LA funds have lower costs and the differential between their costs is less. This is mainly due to the larger number of small DB schemes in the private sector that have higher per unit costs.

8. However, these average costs, in both private sector DB and LA funds hide a great deal of variation. Figure 1 shows a key driver of this variation in DB scheme is size, with the larger DB schemes having lower costs.

[2] Statistical release: LGPS Funds England 2011-12, DCLG, October 2012.

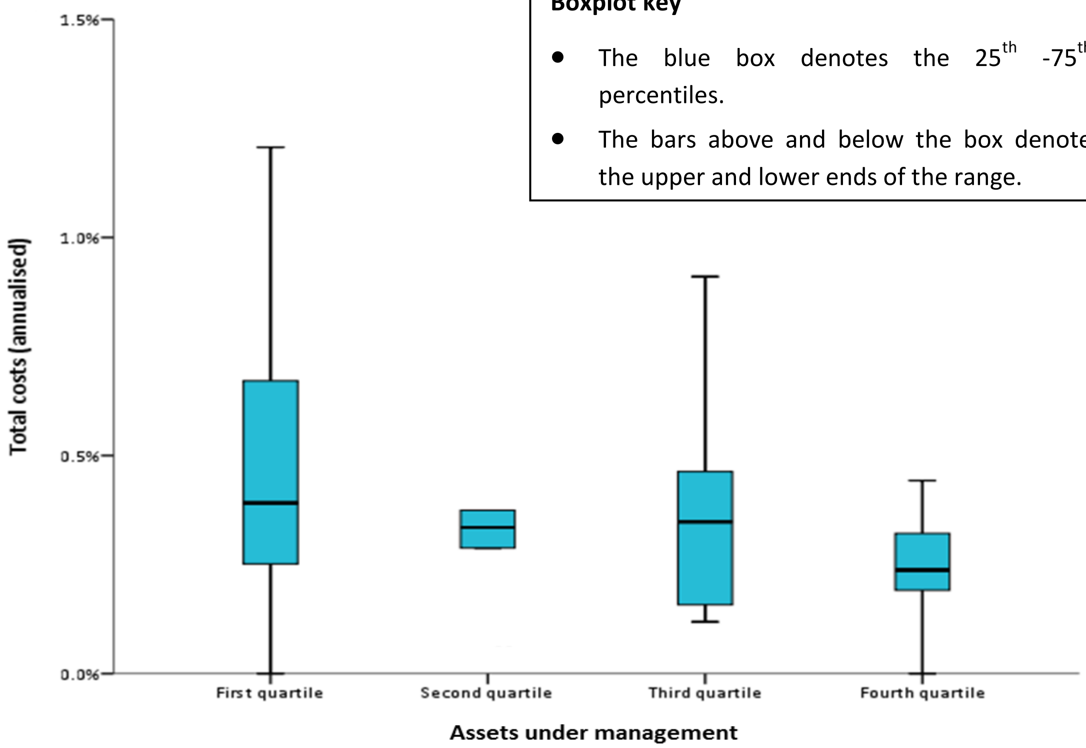
[3] This is consistent with OFT's recent analysis of the workplace DC pensions market which found that the average AMC is 51bps. Defined contribution workplace pensions market study, OFT, September 2013.

[4] NAPF Annual Survey 2012.

Figure 1: private sector DB scheme costs (%s) by size (AUM)

Boxplot key

- The blue box denotes the 25th -75th percentiles.
- The bars above and below the box denote the upper and lower ends of the range.

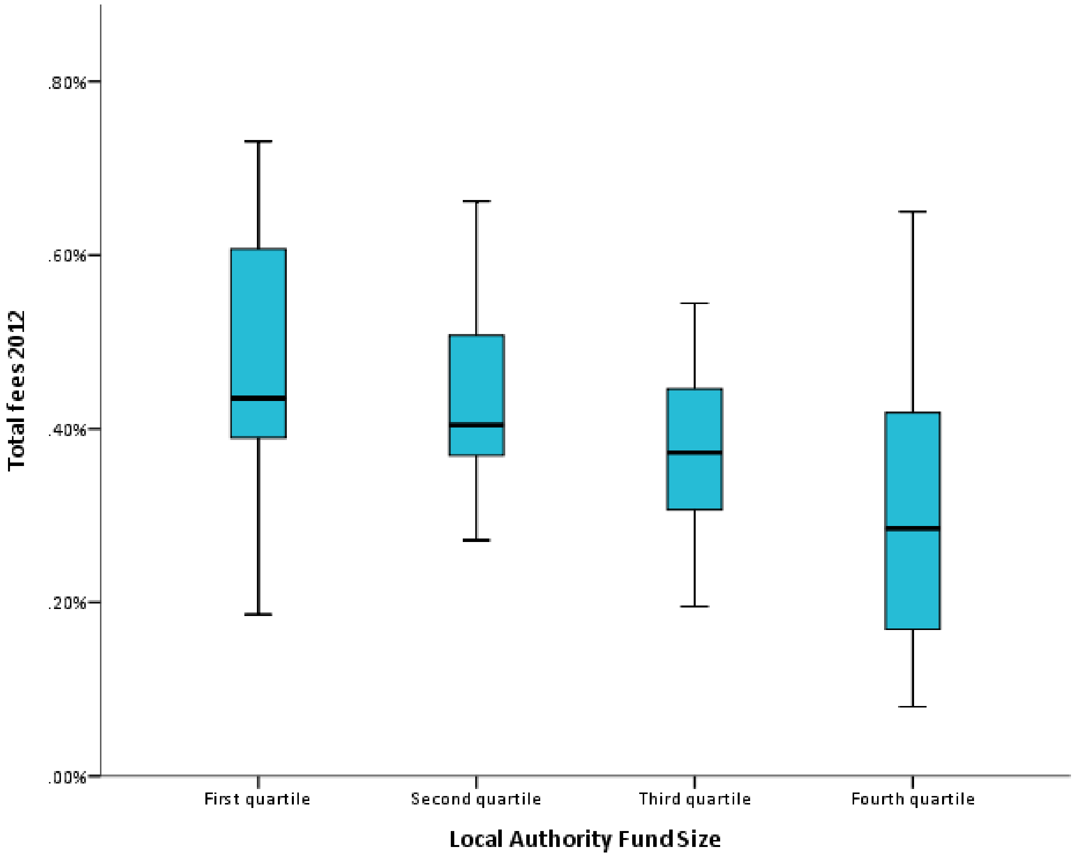


Source: NAPF Annual Survey 2012

9. In order to fully interrogate the variation of costs within the LGPS we undertook a comprehensive analysis of the data from LA fund annual reports over the last three years (2009/10 - 2011/12). The data shows that the average AMC for LA funds drops from 48bps for those in the first quartile (£0-£669m) to 30bps for those in the fourth quartile (£2,197m and over)[5]. Figure 2 shows a detailed breakdown of the range of costs within each quartile. There is a clear trend of costs reducing as fund size increases. However the large range of costs in the fourth quartile suggests that some larger LA funds could still be doing more to drive greater efficiencies so size does not guarantee lower costs. The average cost for funds in the fourth quartile would be lower if it was not driven upward by some larger funds with greater costs.

[5] NAPF LA fund annual report analysis 2009/10-2011/12, September 2013.

Figure 2: LA fund range of costs (%) by size (AUM)

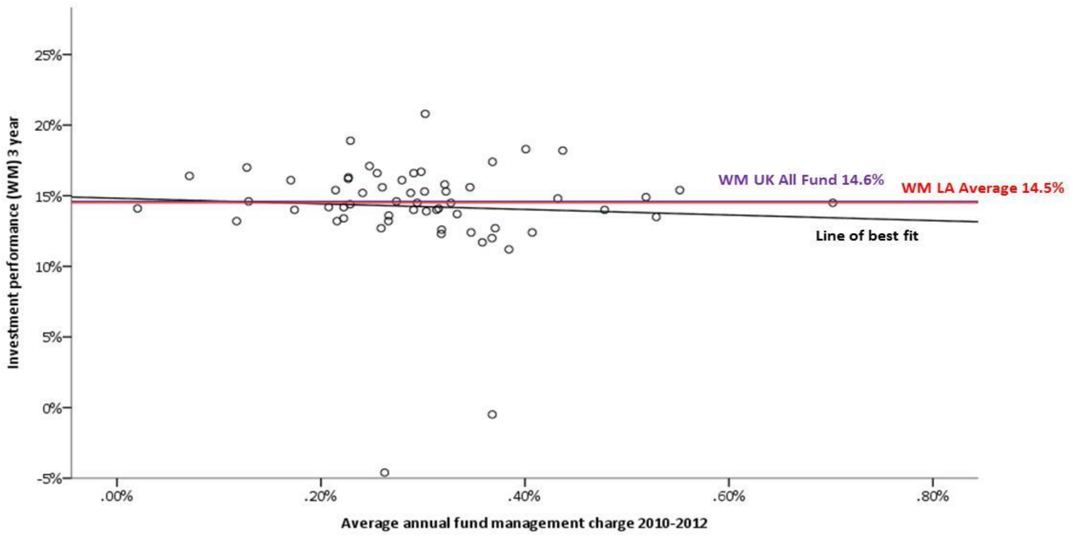


Source: NAPF LA fund annual report analysis 2009/10-2011/12, September 2013

10. The majority of LA fund costs in 2012, £353m, were spent on fund management fees[6]. The NAPF Annual Survey 2012 supports this finding, as the most significant cost for LA funds was fund management and custody, at £96 per member, although these had decreased from 2011 (£110)[7]. Given that investment costs make up the majority of fund costs some correlation between these costs and the performance of the investments might be expected. However, figure 3 shows that, over the last three years, there is a slight inverse correlation between investment fees and net performance, ie those paying less in performance fees are actually seeing marginally better investment performance.

[6] Statistical release: LGPS Funds England 2011-12, DCLG, October 2012.
[7] NAPF Annual Survey 2012.

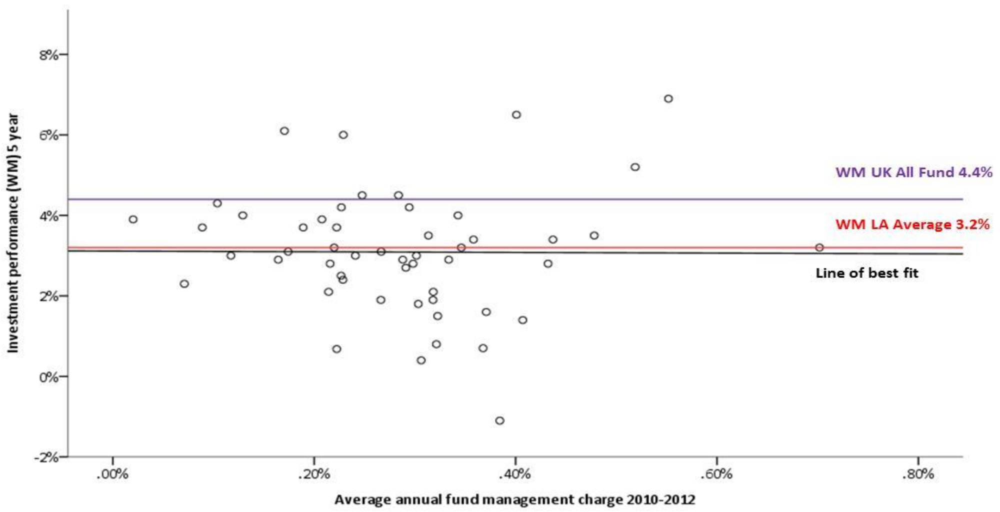
Figure 3: Average annual net investment return over the last five years (%) plotted against investment fees (%)



Source: NAPF LA fund annual report analysis 2009/10-2011/12, September 2013

11. This correlation is also continued when the last five years investment performance is analysed. Figure 4 also seems to suggest that the majority of LA funds performed less well that the average UK fund over the last five years.

Figure 4: Average annual net investment return over five years (%) plotted against investment fees (%)



Source: NAPF LA fund annual report analysis 2009/10-2011/12, September 2013

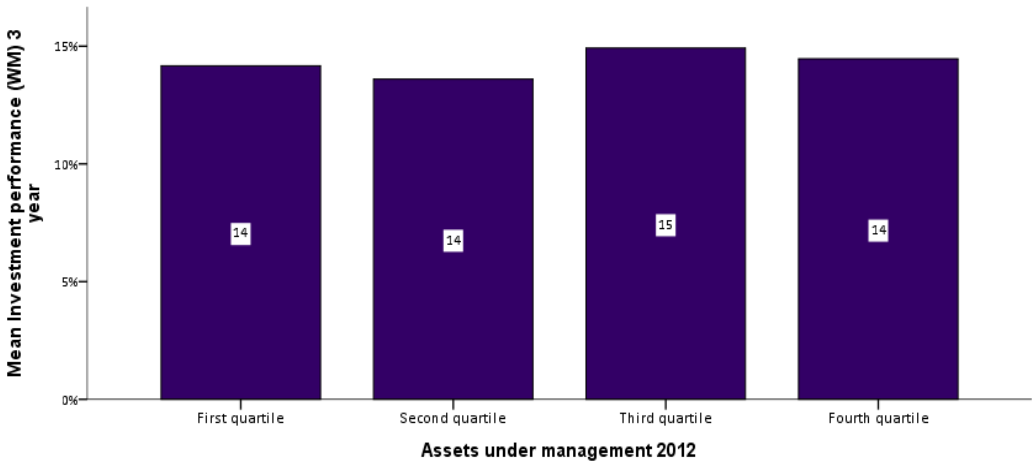
12. Figure 5 shows very little variation in investment performance of LA funds by size (quartile). Overall, this analysis of LA fund investment appears to suggest that there is little or no direct link

between an LA fund's size/investment fees and its investment performance over the last three to five years. However this is not necessarily conclusive.

13. There have been a number of reports analysing the investment performance of the LGPS funds with differing conclusions. Analysis undertaken over a longer period, by APG, showed that from 2001-2009 LA funds realised an investment return of 1.7 per annum, 1% higher than the benchmark return for that period. This research also showed large differences in investment performance between LA funds and revealed that larger LA funds consistently achieved higher investment returns over this period[8]. A Hymans Robertson report that analysed 10 year performance figures for the LGPS showed that larger funds out-performed by 0.6%, although mainly due to maximising economies of scale through more internal management and better diversification of assets[9].

14. However, a PwC report on London fund performance showed that 18 out of the 28 funds under review had out-performed the biggest fund in the group. What is clear is that there is a diversity of views regarding LGPS investment performance and any link to scale. However, the finding that does appear to remain consistent in all reports is that it is internal management that delivers real results, with internally managed funds consistently outperforming externally managed funds across all asset classes over the long term[10].

Figure 5: Average annual investment return over three years (%) by size quartile



Source: NAPF LA fund annual report analysis 2009/10-2011/12, September 2013

15. CLG data suggests that there has also been a steady increase in total costs across the LGPS since 2008-09. Our analysis of LA funds shows that, as a percentage of the AUM, costs have remained

[8] Performance analysis of LGPS funds, Ruben Laros and Maurits Aben, APG Groep NV. The benchmark return was constructed from the relative size of the asset class multiplied by the corresponding benchmark for that asset class.
[9] Welsh LGPS: Working Together (Interim Report), PwC, March 2013. The Hymans report was cited here. The period of performance under review and the proportion of the LGPS covered were not disclosed.
[10] Lessons from Internally Managed Funds, State Street Investment Analytics (WM Company), March 2013. This outperformance is net of transaction costs but excludes investment management costs, when costs are taken into account the level of outperformance increases.

broadly the same over the last three years, suggesting that rising costs are largely down to growing investment costs associated with increased AUM.

16. The NAPF conducted this analysis of LA fund data with the aim of presenting a clearer picture of costs within the LGPS, and how this varies by size and in comparison with funds in the private sector. The analysis shows that larger funds in both the LGPS and the private sector can have lower costs, although whether this delivers better investment performance is less clear over the last three to five years.

17. There is a lot of data available on how LGPS funds operate and this has improved immeasurably over the last decade. However the funds themselves are aware that there continue to be problems with the way costs are currently quoted for administration and investment in annual reports. Of particular concern is that investment costs do not represent an accurate figure of the full costs involved, as they do not include transaction costs and fund-of-fund costs, which could increase costs significantly. A recent report from Hymans Robertson suggests that actual investment costs are double what is currently disclosed under current accounting conventions, at around 63bps rather than the 32bps quoted in the DCLG data[11]. One of the additional challenges we faced when undertaking the analysis of investment performance was the fact that not all funds reported their investment performance in the same way or on the same basis, making direct comparisons difficult.

18. Investment performance is critical not just for fund cash flow, but also the ability to plug deficits. However it is not just the net performance that is important, but how this links to the individual fund's investment strategy and whether it is performing in such a way as to achieve full funding over time. Like charges, the funding levels of LA funds vary widely and are often based on very different assumptions about the discount rate, which in turn drives differing employer contributions and ultimately determines fund cash flow.

19. One of the ways LA funds have been responding to the challenge of meeting their liabilities has been through changes to their investment strategies. While LA fund asset allocations have not seen a radical shift over the last decade there have been some changes. Partly, these reflect the difficult economic climate but there has also a shift towards more specialist management as funds try to find ways to seek return whilst managing volatility. Equity holdings still dominate but there has been a gradual shift away from UK equities to more global mandates. Holdings of conventional and index-linked gilts have decreased, offset by increases in 'other fixed income'. The NAPF's analysis suggests that the on-going trend towards greater diversification is likely to continue. NAPF polling suggests that, over the next three to five years, LA funds are expecting a move away, predominantly, from equities towards 'other' assets such as property and infrastructure[12]. One of the arguments being made for greater consolidation within the LGPS is that larger funds are better able to access these alternative assets thereby securing alternative sources of return. This has wider implications for further consolidation of funds as larger funds are more likely to hold alternative assets. This will need to be taken into account in any analysis of the wider impact of consolidation.

[11] Investment management costs in the LGPS: global benchmarking study, September 2013.
[12] Local Government Pensions Scheme 2013: investing in a changing world, NAPF, May 2013.

20. The NAPF analysis of the costs of the current system shows that larger funds in both the LGPS and the private sector have the potential to achieve lower costs, although whether this delivers better investment performance is less clear, particularly over the last three to five years. More fundamentally this analysis has highlighted a number of areas where more consistent data is required in order to make a more accurate assessment. In particular there needs to be consistent disclosure of costs and investment performance.

21. The Minister for Local Government has asked the Shadow Scheme Advisory Board to help produce an annual report for the LGPS which brings together data from all the funds in England and Wales. Such data will provide proper analysis of how well individual funds are performing across a range of factors, such as funding levels, governance, investment strategies, and administration costs. It will give us not only a fund-by-fund comparison but also a holistic picture of the strengths and weaknesses of the scheme. It will also show where the scheme and funds compare favourably or less favourably with private sector counterparts. Finally, it will enable a truly accurate assessment of the options for further consolidation being debated as part of this call for evidence.

Recommendation

The LGPS Annual Report - currently being developed by the Shadow Board - enables the collection of information about the operation of LA funds in a consistent and accurate manner.

The wider case for reform

22. Lord Hutton's review of public service pensions examined the administration and running costs of the individual LA funds. Lord Hutton argued that the obvious question was whether there may be scope for streamlining and combining administration functions to increase efficiency and value for money, noting international evidence that shows scale can significantly reduce the costs of administration[13]. Our analysis suggests that the larger funds tend to have lower costs. Lord Hutton's review noted that a number of LA funds had begun to explore the opportunity of sharing administrative services and contracts.

The global evidence

23. There is an argument that with £150bn of assets under management the LGPS should be able to make even greater cost savings, in particular through lower investment fees. There is a wealth of international evidence that scale can drive efficiencies in schemes through reduced operating costs and improved investment performance. For example, some of the larger DC schemes have very low fees. In Australia, QSuper (with AS$32bn - £20bn AUM) has investment fees of just 8bps. Globally, pension schemes have been following a trend of consolidation in the Netherlands, Denmark, Canada, the US and Australia in particular. This has been driven by government intervention and regulatory reform, coinciding with pressure from sponsors to reduce costs and drive efficiencies. Even in the UK there have been recent examples of DB schemes merging to drive down costs. For example Serco and Johnson Group both recently announced that they would be merging their pension schemes in order to deliver administration and investment efficiencies.

Global examples of consolidation:

- Australia's superannuation system is projected to reduce from 447 funds to 74 funds by 2035.
- The number of pension funds in Mexico has decreased from 22 to 12 over the last 7 years.
- The Swedish government recently recommended consolidating five state funds into three.

24. Many of the costs associated with scheme administration are fixed costs or costs that do not increase proportionally with size, for example member communications, record keeping, IT functions. Larger schemes are able to reduce these fixed costs by spreading them over a larger membership base[14]. Similar efficiencies are available to larger schemes when it comes to their investment costs, with larger funds typically paying lower investment fees than smaller ones as they are able to use their superior buying power to negotiate down fees and charges. This can also been seen in DC schemes in the UK. Analysis by the Department for Work and Pensions demonstrates a clear correlation between DC scheme size and the annual management charge[15].

[13] Hutton Commission Interim Report, 2011.
[14] Pensions Fund Efficiency: the impact of scale, governance and plan design, DNB Working Paper No.109, August 2006
[15] Pensions landscape and charging, DWP, June 2012.

25. Academic research also suggests that larger schemes are more likely to outperform smaller schemes. Research by Dyck and Pomorski suggests that the largest schemes (those with around $35bn - £22bn AUM) outperform smaller ones by 43-50bps a year[16]. It has been suggested that, if this outperformance was translated to the LGPS, this would be the equivalent of increased investment returns of £750 million per annum[17]. That said, our evidence suggests that the evidence linking size and investment performance within the LGPS is inconsistent at present which may mean that this theory has yet to be proven in a UK context. Between one third and a half of the extra returns cited in the research arise from the cost savings related to internal management, where costs are at least three times lower than external management. The internal management approach is already adopted by many of the UK's largest DB schemes, including some of the larger LA funds.

26. But it is not just about delivering greater efficiencies. Most of the superior returns come from large schemes' ability to have more sophisticated and innovative investment strategies. Access to higher quality advice and in-house expertise means larger schemes are able to invest in asset classes that smaller schemes cannot. Larger schemes therefore tend to have increased allocation to alternative investments and are realising greater returns in this asset class. In their private equity and real estate investment large schemes have both lower costs and higher gross returns, yielding up to 6% per year improvement in returns[18]. This behaviour can also be seen in the LGPS where larger funds tend to hold greater amounts in alternative assets such as infrastructure and private equity[19]. However, it could be argued that smaller funds could access such investment through the use of pooling, rather than through full fund merger. The Pensions Infrastructure Platform is being set up with the specific aim of support pension funds investing in infrastructure in a way that is designed to meet their long term interests. At the other end of the scale there may also be the problem of large funds getting too big which puts pressure on limited investment manager capacity and may make it difficult for funds to switch in and out of large positions.

27. Finally, the ability to take advantage of scale depends on good fund governance with better-governed funds better able to realise the benefits of economies of scale. In its risk-analysis of DC trust-based pensions landscape, the Pensions Regulator argues that larger schemes are more likely to have higher standards of scheme governance. This is because they are better able to appoint high quality trustees, devote the time and focus needed to trusteeship and appoint the right professionals to support board, supported by a dedicated pensions executive[20].

What is already happening

28. LA funds have already recognised that by working together they can achieve greater efficiencies. Cambridgeshire and Northamptonshire and Wandsworth and Camden have been sharing business support services, such as HR, Finance, Legal and particularly IT, in order to deliver efficiencies in the administration of their funds. The South West Framework is a pooled

[16] Is Bigger Better? Size and performance in pension plan management, Alexander Dyck and Lukasz Pomorski, Rotman School, July 2011.
[17] Reconfiguring the London LGPS funds: evaluation of options, PwC, October 2012.
[18] Is Bigger Better? Size and performance in pension plan management, Alexander Dyck and Lukasz Pomorski, Rotman School, July 2011.
[19] Local Government Pensions Scheme 2013: investing in a changing world, NAPF, May 2013.
[20] DC trust-based pension scheme features, TPR, January 2013.

procurement programme put in place in 2011 to help manage down costs. There are also the national framework agreements where the latest, on investment consultancy services, was agreed earlier this year.

29. Anecdotal evidence from NAPF LA members suggests that shared services and procurement contracts are creating real cost savings. The National LGPS frameworks are designed to reduce procurement timescales from six to nine months to as little as four to six weeks, with procurement cost savings of up to 90%[21]. Lord Hutton's review recommended that central and local government should closely monitor the benefits associated with the current joint-working projects (such as the National Procurement Framework) within the LGPS, with a view to encouraging the extension of this approach[22].

30. Some LA funds are also in discussion about further consolidation. Oxfordshire, Buckinghamshire and Berkshire are in preliminary talks about merging their funds, and the Wandsworth Council Pension Fund is planning to lead a London-wide collective investment vehicle. The Government should ensure that such projects are able to proceed and that they are properly evaluated. These projects have the potential to provide valuable evidence and lessons for wider consolidation in the future. There are a number of legal changes required to enable such initiatives and the Government needs to ensure that any legislative barriers can be overcome to so that such projects do not fall at the first legal hurdle. Another potential barrier for funds is the ability to secure internal investment expertise in certain locations and on a public sector pay scale. If the Government would like to achieve real investment efficiencies this will need to be reviewed.

31. This activity clearly demonstrates recognition amongst LA funds of the benefits of working together. The key question for this call for evidence, and the subsequent consultation, is what efficiencies this is delivering and what might be achieved were these frameworks rolled out nationally.

Recommendation

That a formal evaluation is undertaken of the cost savings from the National LGPS Framework - this could be taken forward by the Shadow Board Value for Money Sub-Committee.

Recommendation

That Government should enable existing consolidation projects by making the necessary legal changes that would allow funds who wish to undertake further consolidation to do so.

[21] http://nationallgpsframeworks.org/benefits-procurement-frameworks.
[22] Hutton Commission Interim Report, 2011.

The objectives

32. In order to define this debate the Call for Evidence set out high-level and secondary objectives. Whilst we have no major objections to the high level objective we believe that this debate should be framed by a more fundamental aim, which we have set out below. We also have specific concerns about the appropriateness of some of the secondary objectives, for example, the objective to invest in more infrastructure, which could contradict the notional fiduciary duty of LA funds. Pension funds can help grow the economy but this is not their primary purpose and it should be articulated as such.

33. In responding to this call for evidence the NAPF set a higher level principle to guide the debate: "that the LGPS should provide good quality pensions that are sustainable and affordable for the taxpayer". We believe that this debate should not be solely focused on cost but also whether other structures could drive better governance and administration. Underlying this overarching principle are what we believe should be the key objectives. Specifically, that further consolidation would:

    - Drive greater efficiencies in both administration and investment expenses;
    - Enable greater investment innovation; and
    - Drive better and more consistent governance of LA funds.

34. In order to assess whether the options currently being debated achieve these objectives we have pulled together the available evidence below. We have also drawn together some tentative conclusions about the potential costs and benefits of the options currently being debated.

The options for reform

35. There is a spectrum of options for further consolidation currently being debated within the LGPS and each has differing degrees of local and central accountability. Below we set out the evidence that has been presented so far for and against each option. Given the lack of data in many areas, this will not provide a full cost benefit analysis of each option. In order to come to a decision about what form(s) of consolidation may be taken forward more thorough analysis is required.

Key Features and Responsibilities	Status Quo	Procurement Collaboration	CIVs	Super Pools	Super Funds
Pensions committee	Local	Local	Local	Local	Cental
Historic deficits	Local	Local	Local	Local	Central
Asset allocation	Local	Local	Local	Central	Central
Appointment of Fund Managers	Local	Local	Central	Central	Central
Liability management	Local	Local	Local	Central	Central
Administration	Local	Local	Local	Central	Central

36. The case for the benefits of **shared services and procurement** is still being developed. The National Procurement Frameworks are still being set up and the limited turnover of LA fund advisors means that it will probably be some time before we have an accurate picture of the full savings that can be achieved. As mentioned previously, anecdotal evidence from NAPF LA members suggests that shared services and procurement contracts are creating real cost savings, particularly in areas where there is already competition, for example investment consultants. Whether savings can be achieved in markets where there are fewer players, such as custodians, remains to be seen. The reduction of procurement timescales from the use of the National LGPS frameworks and the ensuing cost savings, would meet the secondary objective of 'driving efficiencies in administration and investment expenses'. However, whatever the outcome of the analysis any savings from these joint procurement exercises are likely to be mainly administrative in nature. Given that the majority of LGPS costs are investment expenses the scope for this work to deliver real efficiencies is likely to remain limited. It will not drive investment innovation and whether it will improve governance remains unclear.

37. A number of LA funds have therefore been discussing the potential merits of establishing a **collective investment vehicle** (CIV). The model proposed by the London Councils would operate by maintaining a selection of funds/asset managers for each asset class. These would be well defined, generally segregated mandates with the CIV using its buying power to secure lower manager fees. The CIV would be responsible for day-to-day governance in relation to each selected manager. LA funds would be free to choose which manager to use from the CIV. Funds would retain their custodians, control over asset allocation and accounting responsibilities. In time the CIV could be used to provide any other investment-related services that funds wished to delegate, for example preparing reports on investment-related matters for pension committees and use of a common custodian.

38. The idea is that this approach allows smaller funds to leverage the buying power of a larger fund whilst still maintaining accountability for the investment strategy and forgoing the complexity involved with a full merger. This could drive efficiencies in investment expenses and enable greater investment innovation. Again, data is an issue, as whilst a large number of funds provide quite detailed data on what they spend on their investment relationships this is not always

broken down by manager and there is no comparison made. Therefore funds cannot necessarily identify which investment mandates need to have their fees renegotiated or market tested. The downside of a CIV compared with a more substantial merger is that it does not allow funds to take advantage of in-house investment expertise so the investment efficiencies may be limited. As shown above, the evidence is that much of the investment efficiencies delivered by larger funds comes from the use of in-house expertise that allows funds to secure lower investment costs whilst increasing their ability to invest in alternative assets that may deliver higher returns at lower risk. Again it is difficult to assess whether this would drive better and more consistent governance as the administering authorities would continue to govern their funds in the same way they do now.

39. As a result the LPFA has put forward a proposal to create a number of **super pools**. The idea is that in addition to the pooling of assets that would take place under a CIV, the super pool is responsible for asset allocation, appointment of fund managers (which may be internal), liability management and administration. Local employers would be responsible for historic deficits and holding the super pool manager to account. In the longer term the pools would be responsible for producing recovery plans for each employer based upon inter alia the covenant of the employer in terms of its financial standing and tax raising powers. Success against this objective will be the achievement of the flight plan for deficit reduction at each valuation point.

40. This option gives the super pools the added efficiency of in-house expertise and associated investment innovation. It may also generate some administration efficiencies, although it is unclear at this stage how much administration would still be required by participating employers. Super pools could deliver a great deal of the efficiency savings experienced by larger funds, whilst avoiding the costs and complexity of full fund mergers. They could also drive better governance of the funds as asset allocations (and potentially recovery plans) would be managed by the super pools enabling it to leverage higher quality governance expertise and oversight.

41. However with administering authorities/individual employers still having responsibility for fund deficits there would need to be unitisation within the ‘pools’ to make sure there is accurate matching of on-going assets and liabilities. Another potential hurdle is the cost of in-house expertise and how this works when funds have to adhere to public sector pay scales. Clearly if in-house expertise is delivering superior returns and lower overall investment costs there should be a case for being able to pay in-house investment managers at commercial rates.

42. There is also the danger that funds could become too big to be truly efficient. One issue is the declining capacity of banks to undertake large derivative trades, which could mean that at some point pension funds become ‘too big’ to implement interest rate and inflation hedging. In addition at some point the outperformance bonus of more sophisticated asset allocations may be offset by investment managers’ capacity to invest and manage increasingly large amounts.

43. What remains unclear at present is the costs of moving to a CIV or super pool arrangement. The careful management of the transition will be key to ensuring that costs and risks (such as disinvestment/transfer of funds) are kept to a minimum. There has been a suggestion that one

way to manage this would be for entry to 'pools' to be done on a buy-in basis, either voluntarily or due to a fund being judged to be 'failing'.

44. The final option is to **fully merge** the 89 funds into a smaller number of larger funds - the exact number has not been decided yet. This has the potential to lead to long term efficiencies as a result of lower administration and investment costs and increased investment performance. It is also likely that larger funds will benefit from the associated governance premium and would therefore have better and more consistent governance.

45. However DB mergers are extremely complex and the funds approaching merger need to ensure that:

    - there is no dilution of the exiting funding ratios; and
    - there is no transfer of value from the members of one scheme to those of another (ie cross-subsidy)[23]

46. If funds have different ratios on the merger valuation basis side payments or receipts are required to produce adjusted funding ratios for schemes that are equal so preventing any cross-subsidy or dilution, such capital sum injection or higher employer contributions paid in respect of the former members of one of the merged funds. The ability to implement a merger without profit or loss depends on the nature and volatility of the market. Therefore the timing of mergers would be crucial to ensuring their success. Any underfunding makes successful merger challenging and the best way to manage this is through the use of cash injections to ensure equality of funding ratios.

47. Cases of DB scheme mergers in the private sector are rare and often involve injections of cash by sponsoring companies to ensure smooth transition. This is because in order to meet the criteria above funds are required to be at least fully funded. For example Serco recently paid £16.8m to eliminate the deficit of its Vertex pension fund, paving the way for it to be transferred into the company's main defined benefit (DB) scheme. LA funds do not face quite the same challenges in terms of deficits appearing on company balance sheets. However, employer budgets are already under strain as a result of public spending cuts and administering authorities and admitted bodies will be hard pressed to find the kind of cash injections that might be required to manage a full merger.

48. The other key problem for merger is the actuarial assumptions used to value the assets and liabilities of the merging funds. In order to rule out profit, loss or cross-subsidies the liabilities need to be valued using an unbiased and consistent forecast of their economic value. The same financial assumptions should be used for both funds as the money will be invested in a pooled manner by the new merged fund. The demographic assumptions may differ because the membership of the two funds may have differing longevity, ill-health or withdrawal rates. However these assumptions need to be consistent, appropriate and adjusted to reflect a fair value, relative to the circumstances of the fund membership. This points to the need for all LA

[23] Merging schemes: an economic analysis of defined benefit pension scheme merger criteria, ISMA Centre, University of Reading, May 2005

funds to be valued using the same actuarial basis for the purposes of comparison, a key role for the new LGPS Annual Report. Therefore any plans to enter into full mergers need to be managed extremely carefully in order to avoid cross-subsidy and to ensure that savings are really achieved.

49. Ultimately we have been unable to accurately assess whether any of the options currently being debated meet the objectives the NAPF set out in this paper. This is primarily because of the lack of accurate and directly comparable data available about both the costs and function of the current scheme as well as the lack of objective data available on the potentials costs and savings that may arise from the consolidation options. There has also been no assessment so far of the wider impact of any major change to the current structure of the LGPS.

Recommendation

That Government undertake a full cost and benefit analysis of the options for further reform including the wider impacts of the scheme, pensioners and the running of local government of another major change.

Managing the transition

50. All of the options set out above have their advantages and disadvantages and a thorough cost-benefit analysis of the current options requires further and more consistent evidence than is currently available. This is why the work on a consistent Annual Report for the LGPS is so critical. As has been mentioned before scheme mergers, consolidation and even joint procurement exercises are not straightforward and there are likely to be wider impacts from any major change. The LGPS is going through a profound period of change and as part of the consideration of the options the most appropriate timescale for any major change needs to be taken into account.

51. As well as the specific pros and cons of each option, there needs to be an assessment of the wider impact of any major structural change. Larger funds are likely to have more sophisticated investment strategies and to invest in alternative assets. Whilst there is a potential upside in terms of the funds ability to invest directly, for example, in UK infrastructure there is also the potential consequence that we will see a greater shift away from UK equities to more global mandates which will have a knock-on impact on UK business investment and stewardship. In addition, any major transformation project requires investment both in terms of money and resource, something the LGPS has limited ability to deliver in the short-term given more immediate priorities. Any transition would need to be managed very carefully.

52. As mentioned at the start, the focus should not be solely focused on cost. The development of the new scheme has generated a welcome debate about what good governance and

administration looks like. This debate should not just be about a race to the bottom in terms of administration and investment fees but about how we can ensure that the LGPS is made up of funds that are well-run, well-governed and operate at a size that offers real value for money for members and the taxpayer.

53. Given the budgetary and resource constraints the LGPS currently faces, any option taken forward needs to be managed very carefully to ensure that costs and risks are well managed. The Shadow Board's work on what 'good' looks like will be highly valuable in developing a holistic model for how a good LA fund should be operating – this includes not just funding levels and investment performance but governance structures and efficient administration.

54. One proposal would be to use this new assessment to drive up quality and promote scale. Funds that do not meet the required level on the 'good' matrix will be put into 'special measures' and a given a period over which to improve their performance, with help from people who have experience of running 'good' funds. Funds that have still not improved at the end of that period will be forced to merge, potentially with other funds that have not performed well. Exactly what form this merger will take is a subject for further discussion. We understand the concerns of well-run funds that they will be forced to merge with funds with poor funding levels, governance and inappropriate investment strategies. We set out some of our concerns in our analysis of the challenges of full scheme mergers above. However we believe that an approach such as this could drive quality as well as efficiency and ensure that consolidation happens in a sensible and timely manner.

Recommendation
That the Government consider the most appropriate method for transitioning to any new structure. Such a method should prioritise the need to ensure funds are well-run and able to continue the vital day job of providing pensions to millions of people.

Conclusion

55. The LGPS is at a critical juncture. It has a critical role - to deliver pensions to 4.6m people - and in order to do so it needs to ensure that its structure is fit for purpose. The status quo cannot continue, nor is it going to do so. There are a number of options for greater consolidation that are worth exploring, although there is data lacking on all of them. This needs addressing urgently, both in terms of the costs of the current scheme and then on the full costs and benefits of further consolidation.

56. Whatever option(s) are taken forward across the LGPS, there needs to be a clear programme of next steps so that funds can manage any change while continuing to do the day job. In the meantime the Government should continue to encourage those funds who wish to do more, not least because voluntary consolidation projects will provide valuable test cases for future consolidation, something that will be invaluable given the lack of available data.

57. Ultimately, the NAPF believes that continuous improvement and consolidation is the best way to ensure that any change is focused on funds building quality and value for money. At the same time change needs to be managed in such a way as to ensure that funds are well run and able to continue the vital day job of providing pensions to millions of people.

Further information

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September 2013