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# LGPS reform: Opportunities for collaboration, cost savings and efficiencies – the NAPF's response

**July 2014**

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# Executive Summary

The NAPF supports the Government's desire to see a Local Government Pension Scheme (LGPS) that delivers good outcomes for participating employers, local taxpayers and scheme members. However we are concerned that the Government's excessive focus on cost reduction at the expense of other factors could ultimately damage the Scheme – in particular those funds which are performing well.

Fundamentally the NAPF believes the real issue is funds who consistently do not perform well, across a matrix of measures. We believe that key to ensuring a high quality, sustainable Scheme is the identification of funds where problems prevail and focusing regulatory intervention on improving their performance.

In responding to the consultation proposals the NAPF has set out three principles against which any reforms should be judged. Reforms should:

- focus on delivering good value for employers, taxpayers and scheme members to ensure the long-term sustainability of the fund, not just low cost;
- ensure that the benefits that can be delivered by collective structures also provide funds with sufficient flexibility to invest in accordance with their local circumstances; and
- align the governance of any new investment structures with the long-term aims of LGPS funds.

Balancing these principles will not be easy. Our analysis suggests that resolving the issues facing the LGPS will be more complex than simply shifting to passive investment management and the use of Collective Investment Vehicles (CIVs). Other strategic options that deliver lower costs whilst maintaining or enhancing good governance should also be considered including internal investment management.

The NAPF recommends that:

- The Government, through the Scheme Advisory Board, should focus on identifying good and bad performance at LGPS fund level and target regulatory interventions to bring poorly-performing funds up to standard.
- There should be no mandation of the use of the passive management. We would support a 'comply or explain' method, whereby funds clearly set out, in their Statement of Investment Principles, the investment strategy and implementation approach. These should be reviewed, firstly by local pension boards, and ultimately the Scheme Advisory Board (SAB) and/or The Pensions Regulator (TPR).
- Whilst we support the development of CIVs we do not believe that investment in one type of CIV should be mandated. Funds should have the flexibility to explore alternative ways of investing collectively that ensure a clear alignment of interests between the investors and those managing the investments. We support the Government setting clear aims and objectives for such vehicles but believe they should be developed from the bottom up. There are a number of potential bodies that could bring funds and lead on the development of these vehicles, for example the SAB.
- The development of collective investment vehicles may require the revision of a number of LGPS

regulations. The Government should be prepared to make the necessary changes to enable the development of well-governed CIVs that meet Local Authority (LA) funds' aims and objectives.

- The LGPS is undergoing a period of significant change. Therefore in order to ensure that any new vehicles are implemented we do not believe this reform can realistically be progressed before the General Election. The Government needs to set out a clear and realistic timetable for reform post May 2015.

## 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 over 16m people and collectively hold assets of around £900bn. Our main objective is to ensure there is a secure and sustainable pensions system in the UK.

# Introduction

1. There has long been a focus on cost management within the Local Government Pension Scheme (LGPS), brought into sharp relief by the Call for Evidence[1] on the most efficient future structure of the Scheme. This has focused, in particular, on investment costs which make up the majority of the LGPS costs (between £409m and £749m, depending on which data are used)[2].

2. The Government's proposals, drawing on work undertaken by Hymans Robertson using data from CEM Benchmarking and others, concludes that cost savings of up to £660m could be made through greater use of passive investment and by using collective investment vehicles (CIVs), particularly to access alternative investments.

3. These are substantial sums and we recognise the importance of driving savings in investment costs, including through greater use of collective structures and passive funds. We are concerned though that the answers proposed by the Government risk alighting on two, very specific, approaches to cost reduction at the expense of others. We are concerned also that the question they are answering may not be the right one, and that rather than asking how LGPS funds can secure liabilities and reduce deficits the consultation asks simply how can they reduce costs.

4. We believe a better approach for taxpayers, LGPS employers and LGPS members, would be to focus on identifying good and bad performance at LGPS fund level. This will necessarily include understanding how funds invest, and at what cost. It will also involve understanding the net returns which funds' investment strategies achieve, the quality of their governance and the extent to which they are reducing deficits. It will enable strong funds to continue to perform strongly, while providing targeted regulatory interventions to bring poorly-performing funds up to standard.

5. Before addressing the specific questions raised in the consultation, the following sections set out:
    - an outline model for an approach to reform based on targeted interventions at the fund level;
    - the types of investment structure that best deliver cost efficiencies and explore the implications of a greater use of 'passive management'; and
    - the benefits and challenges of collaborative and collectivised investment.

[1] DCLG-LGA Call for evidence on the future structure of the Local Government Pension Scheme, June 2013.
[2] £409m based on Department for Communities and Local Government Sf3 data, October 2013 and £745m based on Hymans Robertson LGPS structure analysis, December 2013.

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## Looking beyond costs

6. The initial Call for Evidence also had a primary objective to reduce fund deficits and the consultation acknowledges that very few solutions were put forward as part of that process. Therefore the Government has asked the Shadow Scheme Advisory Board (SSAB) to consider how deficits might be addressed in the longer term.

7. The NAPF welcomes this work which will be critical to the long-term sustainability of the LGPS. Even if the Government were able to generate the projected cost savings set out in the consultation, this would have limited impact on the £47bn deficit in the LGPS.

8. In terms of tackling this issue, we suggest an initial focus on ensuring that LGPS funds are consistently well run. Some funds are not performing as well as they could be across a range of measures and small improvements in governance standards and the resulting uplift in investment performance and greater cost-efficiency could make a real impact to funds' funding positions. We support the SSAB's work to develop a matrix of measures of what a 'good' fund looks like. This will enable the sharing of good practice and give local pension boards a framework for assessing their pension committees.

9. The SSAB has been considering a list of indicators that, while not individually demonstrative of a fund being in good or bad health; need to be looked at as a whole, to ascertain whether or not funds are performing satisfactorily. For example:
   - Funding level calculated at the last triennial valuation on consistent assumptions, by comparison with the proportion of the fund's deficit (calculated on the same consistent assumptions) which is being paid off annually.
   - Historic net investment returns (over 1, 3 and 5 year period) as compared with the fund's required future investment returns.
   - Historic net investment returns (over 1, 3 and 5 year period) as compared with other LGPS funds (median measurement).
   - A deficit spread period which is reducing each triennial valuation.
   - Net inward cash flows as a proportion of fund assets.
   - Investment costs reported on a consistent and transparent basis.
   - Administration costs reported on a consistent and transparent basis.
   - A measure of fund liabilities considering factors that cause local variation in that fund's liability profile.

10. Alongside these financial measures, the SSAB is developing a set of non-financial indicators covering areas such as governance, administration, staffing and resources, quality,

communications and transparency that will also be critical to determining what "good" looks like, and how to distinguish a high performing from a less well performing fund.

11. It is this performance assessment provided by the matrix that should guide regulatory interventions. For example, if a fund has been found to be underperforming and been given a period to come up to standard and failed, the Scheme Advisory Board (SAB) or The Pensions Regulator (TPR) could have the power to change members of the pensions committee, as it does in the private sector in extremis. And funds who consistently fail to demonstrate effective management of assets (including the tactical allocation of such assets) could have their investment decision-making powers removed.

12. By focusing on those funds that are not doing as well as they could be, it is possible to achieve the Government's – and the NAPF's – objective of raising standards and driving better value for money across the LGPS without damaging the considerable good practice that already exists. Well performing funds could continue to utilise the investment strategies that have driven consistent outperformance whilst valuable energy is focused on those who most need it.

# Passive to active management

13. One of the key proposals in the consultation is that LGPS funds should be moved from active to passive management in order to reduce costs. While it is undoubtedly the case that, on average, passive styles can be delivered at a lower cost than active, alternative changes in investment style may also yield significant cost savings.

**How pension funds invest**

14. Pension funds – even very large funds – do not implement their strategy in a simplistic 'internal passive v active' manner. Funds marry a combination of approaches into an overall strategy. There are also basic philosophies that drive decision making. These are evident in each scheme's Statement of Investment Principles. For example, a particular scheme may choose to be active in one asset class and passive in another for very good reasons, for example diversification or inflation-matching, just as they are likely to choose internal or external for equally good reasons.

15. Importantly though, scale plays a part. Many small funds simply are not big enough to implement internal management. The following table highlights how the implementation strategy across 18 representative LGPS funds[3] that make up CEM's 'Combined LGPS' group compares with that of a peer group of 15 of the largest funds in the CEM universe with assets in the range £67bn to £408bn (average £135bn).

**Table 1: weighting of implementation style for LGPS and Peer Group**

| | Combined LGPS | Peer Group of Large Global Funds |
|---|---|---|
| Internal Passive | 13% | 24% |
| Internal Active | 3% | 26% |
| External Passive | 24% | 7% |
| External Active | 60% | 43% |

16. Table 1 reveals that even the world's largest funds invest a significant proportion of their assets externally and employ active management. Large funds also tend to manage a much higher proportion of their assets internally.

**How does implementation style impact on investment costs?**

17. The impact of various 'implementation styles' (external active, internal active, external passive, internal passive) on the public market assets of LGPS are considered below. The data used for this purpose was supplied by CEM Benchmarking. These data include cost comparisons based on different implementation styles for CEM's universe of global pension scheme clients supplying data in 2012. This comprised over 350 (mainly DB) pension funds from around the world from £27m to £400bn with combined assets of over £4.5tn (median £2.8bn).

18. The CEM data reveal the following costs for different implementation styles and a range of asset classes.

[3] These 18 funds were selected by CEM from a wider universe supplying data as representative of LGPS in England and Wales as a whole, based largely on size.

**Table 2: Median costs of different implementation styles across asset classes.**

| Asset Class | Median Cost for External Active (bps) | Median Cost for External Passive (bps) | Median Cost for Internal Active (bps) | Median Cost for Internal Passive (bps) | Median Cost for Fund-of-Funds (bps) |
|---|---|---|---|---|---|
| UK Stock | 61 | 5 | 7 | 2 | |
| US Stock | 48 | 3 | 10 | 1 | |
| Europe Stock | 38 | 8 | 3 | 4 | |
| Asia Pacific Stock | 57 | 9 | 12 | 5 | |
| Emerging Stock | 73 | 15 | 17 | 7 | |
| Global Equities | 47 | 6 | 8 | 5 | |
| | | | | | |
| Fixed Income – UK | 25 | 9 | 5 | - | |
| Fixed Income Inflation Linked | 15 | 4 | 2 | 2 | |
| Fixed Income - Global Government | 7 | 5 | 3 | - | |
| Fixed Income - Global Credit | 30 | 9 | 1 | - | |
| Fixed income – Other | 20 | 5 | 6 | 1 | |
| | | | | | |
| Commodities | 61 | 19 | 21 | 3 | |
| REITS | 53 | 10 | 6 | 1 | |
| Real Estate | 75 | - | 25 | - | |
| Infrastructure | 109 | - | 33 | - | 151 |
| Private Equity | 165 | - | 30* | - | 251 |
| Hedge Funds | 154 | - | - | - | 259 |

Source: CEM Benchmarking
*includes a combination of internal 'direct deal making' and co-investments

19. These data illustrate that:
    - external active management is by far the most expensive implementation style;
    - internal active management is much lower cost than external active management;
    - the difference in cost between internal active and passive management is negligible;
    - alternative assets are, in most cases, significantly more expensive than public market assets; and
    - fund-of-fund structures add an additional layer of fees on these expensive asset classes.

20. The relative cost differential for the different implementation styles can be quantified for the LGPS as follows:

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**Table 3: Weighted global costs of the different implementation styles using LGPS asset allocation**

| | | Basis point costs based on CEM global cost data (weighted by allocation to individual asset class) | | | |
|---|---|---|---|---|---|
| | **NAPF Annual Survey 2013 LGPS Asset Allocation (%)** | External Active | External Passive | Internal Active | Internal Passive |
| Equities | **56.5** | 30 | 3 | 5 | 2 |
| Fixed | **16.5** | 4 | 1 | 1 | 0 |
| Other | **27** | 19 | 15 | 6 | 5 |
| Total | | 53 | 19 | 11 | 7 |

Source: NAPF analysis using CEM global universe data

21. This table shows the costs of each implementation style based on typical global cost differentials[4] for individual asset classes and applied to the overall asset allocation of the LGPS. Unsurprisingly 100% external active management was the most expensive. If the current LGPS asset allocation were solely invested via external active management it would cost 53 basis points (bps) or £945m a year. However, at the other end of the scale if the full £178bn were invested solely through internal passive management it could cost as little as 7 bps, or £125m. Using the Hymans investment costs of £749m, investing via internal active management at 11 bps per annum offers the possibility of realising £553m of cost savings whilst still allowing funds to invest actively.

22. Pursuing investment cost savings through greater use of internal management has wider benefits as well. A number of reports demonstrate that internal management can deliver real results, with internally managed funds consistently outperforming externally managed funds across all asset classes over the long term[5]. This is supported by the CEM database, which reveals that, on average, funds employing internal management perform better – a 10% increase in internal management equates to an average 3.3 bps increase in net value added. CEM suggest that this is largely due to cost.

23. One challenge with increased internal management for Local Authority (LA) funds is whether such teams would be subject to public sector pay constraints. Applying such constraints to internal management in the LGPS (be it via a CIV or other collective investment) may limit the ability to attract the necessary expertise to run such investments.

**Passive management and the economy**

24. There are also wider considerations of a wholescale move to passive for all listed assets that the Government needs to consider. Given the extent of active management within the LGPS (68%) the macro-economic impact of any such shift must be explored fully. The LGPS still invests a one

[4] Footnote: CEM's cost analysis includes external manager fees, including performance fees, plus the cost of internal oversight of external assets where applicable on a 'fully loaded' basis (i.e., including all internal and external overheads as well as the time and cost of the internal team). Transaction costs are excluded as are performance fees in private markets (both of which are material but difficult to collect and compare). Where there was no cost available under one or more of the different investment approaches we used the cost that was available, assuming that this asset class would continue to be invested this way. For example Hedge fund costs are only available under external active approaches.

[5] 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.

fifth of its assets in UK equities and therefore the impact of any shift on UK listed companies, in particular small and medium sized companies, could be material.

**Legislative challenges**

25. Any mandation of passive investment also poses potential legislative challenges. Passive investment is difficult to define, for example, it could be argued that an 'active' buy and hold strategy is passive. Any definition is also unlikely to remain consistent over time especially given the ever-changing nature of investment structures. This lack of clarity about what passive is could make it difficult for Government to legislate for the mandation of passive investment by LA funds.

26. In conclusion, the NAPF's analysis shows that moving to greater use of internal active management could enable the Government to generate the kind of cost savings it is looking to achieve without damaging the potential outperformance (and deficit reduction) being generated by some LGPS funds.

27. **Given the potential to achieve similar levels of savings through the use of internal management and the wider potential consequences of moving all LGPS listed assets to passive, the NAPF recommends against the mandated use of the passive management.** However we recognise that, as part of good governance LGPS should be considering the extent to which they utilise passive management as part of their wider investment strategy and ensuring their investments provide value for money. **Therefore the NAPF supports a 'comply or explain' method, whereby funds clearly set out, in their Statement of Investment Principles, the investment strategy and implementation approach.** These should be reviewed, firstly by local pension boards, and ultimately the Scheme Advisory Board and/or the Pension's Regulator.

# Collaborative and collective investment mechanisms

28. Investment cost is only one part of delivering value for money, performance is another key element. There have been a number of reports analysing the investment performance of the LGPS funds over recent years, with differing conclusions. The Hymans Robertson analysis quoted in the consultation shows LGPS achieving aggregate investment returns on or about the 'passive' level of return of the relevant index. Therefore, net of fees, the LGPS as a whole had underperformed the benchmark by 0.34% in the ten years to the end of 2011[6].

29. Whilst, in aggregate, the performance of LGPS funds is on, or about, the index the NAPF is concerned that focusing on aggregate figures risks hiding the key factors that may drive some funds to consistently out-perform. For example, CEM analysis shows size is a driving factor with larger funds, on average, outperforming smaller funds and one of the main sources of that outperformance is lower costs. The CEM data reveal that, for every ten-fold increase in size, net value added increases by 15 bps. For example, net value added is expected to be higher by 15 bps for a £1bn fund compared with a £100m fund. This is partly because large funds have had higher weights in asset classes where value added has been positive. After adjusting for these asset mix variations (to focus just on the cost impact), net value added was 8 bps higher for a £1bn fund compared with a £100m fund. CEM suggests that the differential is largely due to cost.

**The governance premium**

30. It is not just size and the level of internal management that drives better performance. The Hymans Robertson report concludes that successful LGPS funds (funds in the 'top 10' in terms of performance) share some combination of the following characteristics:
    - they use a limited number of managers;
    - they retain their managers for the long term, through periods of inevitable underperformance; and/or
    - they adopt a simple structure focused on equities, bonds and property.

31. Internal management also featured on that list, but most of these factors are a feature of good governance of the scheme - and focusing on the fund's primary role to produce stable, long-term cash flows that meet the pension liabilities as they fall due. This is important, because any improvements in governance that could raise the performance of the lower performing funds up to average could deliver financial returns that could exceed those identified for the move to passive management (£230m per annum). Table 10 of the Hymans Robertson report notes a median return over eight years of 7.4% a year. The lower quartile return is 6.7%. If this one quartile of funds were boosted to the current median this could improve performance by 0.7% or £315m a year.

[6] Hymans Robertson LGPS structure analysis, December 2013.

32. Therefore the NAPF would argue that collective investment structures present an opportunity to harness economies of scale to drive down investment cost, allow greater internal investment and improve investment governance. As the NAPF set out in its response to the Call for Evidence, 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 8 bps.[7]

33. Collaborative investment involves the assets of more investor being invested jointly or 'pooled'. The exact nature of this joint investment will depend on the structure of arrangement chosen along with its investors' objectives and any legislative requirements. CIVs are one type of collaborative investment but there are other arrangements, such co-investment in infrastructure projects and the use of joint committees to discharge scheme manager functions. Box 1 set out some examples.

**Box 1: Examples of collaborative investment**

- The M8 motorway project is one recent example of a pension fund entering into a co-investment arrangement. The project is being financed by a £350m loan provided jointly by the European Investment Bank, Allianz and the GEC Pension Fund.
- In Columbia four pension funds have agreed to co-invest $12.7 billion in road infrastructure projects over the next seven years.
- Administering authorities can use the powers in the LG Act 1972 section 101(1)(b) for their functions to be discharged by another local authority. Using this power some or all of one administering authority's investment function could be performed by a separate administering authority. This could be particularly useful for specific types of alternatives where one authority could specialise in selecting and managing an alternative asset on behalf of a group. Such arrangements could potentially lead to lower fees, direct access to markets and reduced manager churn.
- Another potential for these arrangements would be for the in-house investment team of one authority to act for others thereby providing the cost advantages of in-house investment and avoiding the need to external manager selection.

**Challenges with establishing CIVs**

34. However, setting up collective investment vehicles is not a simple task. The NAPF has had significant experience of establishing a collective investment vehicle, the Pensions Infrastructure Platform (PIP).

35. The PIP is an example of how funds can collaborate to combine their strength and achieve scale, getting them a better deal from infrastructure managers. But even with the relatively small number of Founding Investors involved in the PIP, some compromise was required to arrive at a vehicle with a governance structure and investment criteria acceptable to all, with the result that some of the initial Founding Investors concluded that the PIP was not suitable for their fund.

36. This was because not all pension funds treat investment in the same asset class in the same way. Not all the PIP's original Founding Investors wanted the same returns, type of financing or even the same infrastructure from their infrastructure investments. A smaller and more closely aligned group of Founding Investors has made compromise easier and the focus tighter.

[7] DCLG-LGA call for evidence on the future structure of the LGPS: An NAPF response.

37. This is one of the factors contributing towards the success of the first fund, as it opens up to a wider group of investors. But it also one of the key challenges posed by having a small number of collective investment vehicles attempting to deliver the full range of investment requirements of all the 89 funds in England and Wales.

38. These 89 funds have considerable diversity in the value of their assets, their funding level, as well as their specific investment objectives and risk appetite. So establishing collective investment opportunities that meet this diversity of requirements is not something that can be done easily or quickly. LA funds need to have the freedom to determine how they can match their assets and liabilities over time and achieve their true aim of providing security to their members. The governance of each collective investment structure will need to ensure that funds have sufficient choice over their investments whilst also continuing to drive cost efficiencies. This will be a difficult balancing act and the NAPF would suggest that having a greater number of collective investment vehicles, as well as other collective investment opportunities, improves the likelihood of funds being able to find the investments that meet their needs and provide value for money.

**Opportunities to build collaboration**

39. One way to ensure the development of vehicles that are governed in a way that ensures a clear alignment between their investors' interests and the underlying investments is to make use of existing collaborative structures. There are existing examples of joint committees that could be used as the basis for collaborative arrangements. For example SIGOMA (Special Interest Group of Metropolitan Authorities) contains 5 of the largest administering authorities. These funds in total account for over £40bn in assets.

40. The Public Service Pensions Act requirement to establish a pension board for each scheme manager provides another opportunity to establish a collaborative structure. LGPS regulations could allow for joint boards where the scheme manager function is wholly or mainly delivered via a joint committee. An arrangement in which most investment governance (and potential investment decisions) have been delegated to the joint committee and are overseen by a joint pension board would meet that requirement. It would also ensure that governing bodies have necessary resource, a depth and continuity of experience to undertake rigorous investment governance.

41. The NAPF would support the LGPS governance regulations allowing for the creation of Joint Boards. Making use of such structures has the potential to speed up the development of collaborative investment models, whilst also ensuring a clear alignment of interests, improving investment governance and generating cost savings.

**CIVs and alternative investments**

42. The scope and nature of alternatives would make the creation of one CIV for 'alternatives' difficult and complex. The range of investments in the 'alternatives' category is diverse and the assets included can be accessed through a variety of different routes and vehicles.

43. However small funds can usually only access these investments using costly fund-of-funds structures. In the Hymans Robertson report it was estimated that 40% of LGPS investment fees are spent on alternatives, which make up less than 10% of assets. The NAPF supports a move away from such structures which fail to deliver the outperformance required to justify their costs. However, we believe that the sheer range of asset classes included in this category calls into question whether one vehicle could have the capacity, expertise, experience and resource to provide the required level of service and performance.

44. Again, the NAPF believes that the LGPS should have the flexibility to develop models for collective investment in alternatives that ensure a clear alignment of interests between the funds and the investment manager and approach. However we recognise that for collective investment of both listed and alternative assets, allowing 'a thousand flowers to bloom' would be counterproductive to achieving the scale and expertise necessary to drive cost and performance. Therefore we propose that **the Government sets a clear framework for the development of these collective investment structures.** This framework could include a set of clear aims and objectives that each structure should be aiming to deliver in order to be deemed viable. The NAPF has set out some initial thoughts on the objectives for a collective investment structure in Box 2.

45. A part of this framework, the Government could also appoint a body, for example the Scheme Advisory Board, with responsibility for driving the development of these vehicles through existing (and potentially new) collaborative structures to a specific, but realistic timeframe. This body could also be empowered to judge whether potential new collective vehicles meet the criteria.

46. It will also be important that funds developing such structures benefit from some central support and expertise. The Government should explore what support it can provide, either through the Scheme Advisory Board or direct to funds.

**Box 2: Collective investment objectives**

- The vehicle must deliver investments that provide a positive, net-of-fees, performance in line with the benchmark for that asset class.
- The Governance and ownership structures of the vehicle must be aligned with the long-term interests of the participating investors to ensure long term performance.
- The projected set up costs of any vehicle should not exceed X% of participating funds' AMC.
- The vehicle must be able to undertake direct internal investments of assets.

# Conclusion

47. The NAPF supports the Government's desire to see a Local Government Pension Scheme (LGPS) that delivers good outcomes for participating employers, local taxpayers and scheme members. However we are concerned that the Government's excessive focus on cost reduction at the expense of other factors could ultimately damage the fund – in particular those funds which are performing well.

48. Fundamentally the NAPF believes the real issue is funds that consistently do not perform well, across a matrix of measures. We believe that key to ensuring a good quality, sustainable Scheme is the identification of funds where problems prevail and focusing regulatory attention on improving their performance.

49. In responding to the consultation proposals the NAPF has undertaken an analysis, which suggests that resolving the issues facing LGPS will be more complex than simply shifting to passive investment management and the use of Collective Investment Vehicles (CIVs). Other strategic options that deliver lower costs whilst maintaining or enhancing good governance should also be considered including internal investment management.

50. The NAPF therefore recommends that:
    - The Government, through the Scheme Advisory Board, should focus on identifying good and bad performance at LGPS fund level and target regulatory interventions to bring poorly-performing funds up to standard. In particular if a fund has been found to be consistently underperforming, the SAB or TPR could have the power to change members of the pensions committee.

    - There should be no mandation of the use of the passive management. We would support a 'comply or explain' method, whereby funds clearly set out, in their Statement of Investment Principles, the investment strategy and implementation approach. These should be reviewed, firstly by local pension boards, and ultimately the SAB and/or TPR.

    - Whilst we support the development of collective investment structures we do not believe that investment in one type of CIV should be mandated. Funds should have the flexibility to explore alternative ways of investing collectively that ensure a clear alignment of interests between the investors and those managing the investments. We support the Government setting clear aims and objectives for such vehicles but believe they should be developed from the bottom up. There are a number of potential bodies that could bring funds and lead on the development of these vehicles, for example the Scheme Advisory Board.

    - The development of CIVs may require the revision of a number of LGPS regulations. The Government should be prepared to make the necessary changes to enable the development of well-governed CIVs that meet LA funds' aims and objectives.

- The LGPS is undergoing a period of significant change. Therefore in order to ensure that any new vehicles are implemented we do not believe this reform can realistically be progress before the General Election. The Government needs to set out a clear and realistic timetable for reform post May 2015.

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# Consultation questions

**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.**

We know that scale can deliver cost-efficiencies and better governance.

However, whether CIVs will deliver this depends on:

- the investment aims of the participating funds; and
- Ensuring these vehicles are structured in a way that avoids unnecessary complexity and deliver good governance as well as increased efficiencies. And are aligned with investors' interests to ensure long term performance and value for money.
- Providing the right CIVs that funds want to invest in.

The most efficient way to ensure that these structures are developed in a way that balances the need for increased efficiency with local pension fund circumstances is for the Government to encourage a range of co-investment structures to be developed by funds (with some central support).

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

It makes sense for those making strategic asset allocation decisions to be the ones that most fully understand the specific situation of each fund.

**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?**

Whilst we support the development of collective investment vehicles where these make sense for collections of funds we do not believe that CIVs should be the only option and funds should have the flexibility to explore alternative ways of co-investing, in particular methods that allow them to make greater use of internal management. We support proposals by the Shadow Scheme Advisory Board that they should lead on the development of these vehicles.

One proposal is that the Government appoints a body, for example the Scheme Advisory Board, with responsibility for driving the development of these vehicles through existing (and potentially new) collaborative structures to a specific, but realistic timeframe. This body could also be empowered to judge whether potential new collective vehicles meet the criteria.

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

Collaborative investment involves the assets of more than one pension fund being invested jointly or 'pooled'. The exact nature of the pooling arrangement will depend on the structure of arrangement chosen along with its investors' objectives and the pre-existing legal strictures on the investors. CIVs would be included in this definition but so too could other arrangements, for example co-investment in infrastructure projects and the use of joint committees to discharge scheme manager functions.

**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?**

There should be no mandation of the use of the passive management. We would support a 'comply or explain' method, whereby funds clearly set out, in their Statement of Investment Principles, the investment strategy and implementation approach. These should be reviewed, firstly by local pension boards, and ultimately the SAB and/or TPR.