



Department for
Communities and
Local Government

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

Consultation

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May 2014

ISBN: 978-1-4098-4190-6

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1. The consultation process and how to respond

Scope of the consultation

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

Basic Information

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

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

Background

Getting to this stage:	<p>This consultation has been developed drawing on three sources of evidence:</p> <ul style="list-style-type: none"> • A call for evidence on the future structure of the Local Government Pension Scheme, which ran from 21 June to 27 September 2013. 133 responses were received and analysed, helping to inform this consultation. • An analysis of the responses to the call for evidence provided by the Shadow Scheme Advisory Board. • Supplementary cost-benefits analysis of proposals for reform commissioned from Hymans Robertson using the Contestable Policy Fund. The commission did not extend to making recommendations. <p>The Shadow Board's analysis, the Hymans Robertson report and the Government's response to the call for evidence are all available on the Government's website: https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies.</p>
Previous engagement:	<p>As outlined above, this consultation follows a call for evidence that gave anyone with an interest in the Scheme the opportunity to inform the Government's thinking on potential structural reform. The call for evidence was run in conjunction with the Local Government Association and the responses were shared with the Shadow Scheme Advisory Board, which provided the Minister for Local Government with their recommendations and analysis of the responses.</p> <p>The call for evidence also drew on a round table event that took place on 16 May 2013 with representatives of administering</p>

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

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

Confidentiality and data protection

- 1.2 Information provided in response to this consultation, including personal information, may be published or disclosed in accordance with the access to information regimes (these are primarily the Freedom of Information Act 2000, the Data Protection Act 1998 and the Environmental Information Regulations 2004).
- 1.3 If you want the information that you provide to be treated as confidential, please be aware that, under the Freedom of Information Act 2000, there is a statutory code of practice with which public authorities must comply and which deals, amongst other things, with obligations of confidence. In view of this it would be helpful if you could explain to us why you regard the information you have provided as confidential. If we receive a request for disclosure of the information we will take full account of your explanation, but we cannot give an assurance that confidentiality can be maintained in all circumstances. An automatic confidentiality disclaimer generated by your IT system will not, in itself, be regarded as binding on the Department.
- 1.4 The Department will process your personal data in accordance with the Data Protection Act 1998 and in the majority of circumstances this will mean that your personal data will not be disclosed to third parties. Individual responses will not be acknowledged unless specifically requested.

Help with queries

- 1.5 Questions about the policy issues raised in the document can be sent to LGPSReform@communities.gsi.gov.uk.
- 1.6 A copy of the Consultation Principles is at www.cabinetoffice.gov.uk/resource-library/consultation-principles-guidance. Are you satisfied that this consultation has followed these principles? If not or you have any other observations about how we can improve the process please email: consultationcoordinator@communities.gsi.gov.uk
- 1.7 Alternatively, you can write to:

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

2. Introduction and background

Introduction

- 2.1 The Government believes that there is scope for significant savings, of £660 million per year, to be achieved through reform of the Local Government Pension Scheme. To that end, from 21 June to 27 September 2013, the Government ran a call for evidence on structural reform of the Local Government Pension Scheme. The paper asked respondents to consider what might be done to improve fund performance and drive efficiencies across the Scheme.
- 2.2 This consultation represents the next step in reform of the Scheme, building on the responses to the call for evidence and further cost benefit analysis of potential options for reform. It sets out the Government's preferred approach to reform and seeks views on the proposals.

Background

- 2.3 With assets of £178 billion in 2012-13, the Local Government Pension Scheme is one of the largest funded pension schemes in Europe. Several thousand employers participate in the Scheme, which has a total of 4.68 million active, deferred and pensioner members.¹ The Department for Communities and Local Government is responsible for the regulatory framework governing the Scheme in England and Wales.
- 2.4 The Scheme is managed through 89 funds which broadly correspond to the county councils following the 1974 local government reorganisation as well as each of the 33 London Boroughs. In most cases, the fund administering authorities are upper tier local authorities such as a county or unitary council, but there are also some administering authorities established specifically to manage their fund, for example the Environment Agency Pension Fund and the London Pension Fund Authority. The fund authorities have individual governance and working arrangements. Each fund has its own funding level, cash-flow and balance of active, deferred and pensioner members, which it takes into account when adopting its investment strategy, which is normally agreed by the councillors on the fund authority's pensions committee.
- 2.5 Employer contributions to the Scheme, the majority of which are funded by taxpayers, were more than £6 billion in 2012-13. The costs of managing and administering the scheme were estimated as being £536 million in 2012-13.² However, the actual costs are likely to be rather higher; the investment costs alone have recently been estimated as in excess of £790 million.³ While investment returns and the costs of providing

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

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

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

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

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

Getting to this stage

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

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

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

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

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

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

⁵ Independent Public Service Pensions Commission: Final Report p.122

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

- 2.11 The Department therefore co-hosted a round-table event to consider these issues with the Local Government Association in May 2013. There were 25 attendees from administering authorities, employers, trade unions, the actuarial profession and academia. The discussion centred on the possible aims of reform, the potential benefits of structural change and the work required to provide robust evidence to analyse the emerging options and establish a starting point and target.
- 2.12 The objectives for reform identified at the round-table fed into a call for evidence on the future structure of the Scheme, which ran from 21 June to 27 September 2013. This asked respondents to set out the data required to enable a reliable comparison of fund performance and to consider how the administration, management and structure of the Scheme might be reformed to address the objectives identified at the round-table event. These objectives included reduced fund deficits and improved investment returns, as well as reduced investment fees and administration costs, greater flexibility of investment, especially in infrastructure and more use of better in-house investment management.
- 2.13 133 responses were received to the call for evidence and these submissions have been analysed to inform this consultation. A separate response to the call for evidence has been published and is available at: <https://www.gov.uk/government/consultations/call-for-evidence-on-the-future-structure-of-the-local-government-pension-scheme>. The Shadow Scheme Advisory Board has also reviewed the responses to the call for evidence and submitted recommendations to the Minister for Local Government. Its findings have been considered in the development of this consultation and are available via a link on its webpage or from the Shadow Board's website: <http://www.lgpsboard.org/index.php/structure-reform/board-analysis-menu>.
- 2.14 To support the call for evidence, the Minister for Local Government and the Minister for the Cabinet Office commissioned additional analysis using the Contestable Policy Fund. The Fund gives Ministers direct access to external policy advice through a centrally managed match fund, allowing Ministers to draw directly on the thinking, evidence and insight of external experts. Following a competitive tender process, Hymans Robertson were selected to establish the aggregate performance of the Scheme by asset class and to provide a detailed cost-benefit analysis of three potential options for reform:
- Establishing one common investment vehicle for all funds;
 - Creating five to ten common investment vehicles for fund assets
 - Merging the existing structure into five to ten funds.
- 2.15 The analysis set out the costs and benefits of each option; the time required to realise savings; the practical and legal barriers to implementation and how they might

be addressed. Hymans Robertson's findings have been reflected in this consultation, alongside the call for evidence responses and analysis by the Shadow Scheme Advisory Board. A copy of the Hymans Robertson report, which did not extend to making recommendations, is available on the Government's website:

<https://www.gov.uk/government/consultations/local-government-pension-scheme-opportunities-for-collaboration-cost-savings-and-efficiencies>

3. The case for change

Summary of the proposals

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

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

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

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

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

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

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

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

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

- 3.6 This package of proposals provides a clear opportunity to substantially reduce the investment costs of the Scheme. They are most effective when adopted by all 89 funds and the Government proposes to implement them together. Indeed, the passive management of listed assets could be most easily facilitated through a common investment vehicle.
- 3.7 In addition, the cost of investment has been estimated to be considerably higher than previously reported. Recognising the need for more reliable and comparable performance and cost data, the Government will continue to work with the Shadow Scheme Advisory Board to improve the transparency of fund data as set out in paragraph 5.3.
- 3.8 The remainder of this section sets out the objectives and rationale for reform and the evidence underpinning the approach taken. A more detailed explanation of the proposals for reform is provided in section four.

The objective of reform

- 3.9 The cost of the Local Government Pension Scheme has risen considerably since the 1990s, with the increased costs falling predominantly on Scheme employers and local taxpayers. In England alone, the cost to Scheme employers has almost quadrupled from £1.5 billion in 1997-98 to £5.7 billion in 2012-13. Indeed, when the Welsh funds are also considered, the total cost to employers is around £6.2 billion a year.⁶ The Government has already taken action to reduce the cost of the Scheme and make it more sustainable and affordable to employers and taxpayers in the long term. For example, the new 2014 Scheme with a revised benefit structure came into effect on 1 April, helping to reduce and rebalance the cost between members and employers. However, it is clear from examining the aggregate data on the Scheme which has come to light as part of this review, that there is more that can be done to improve the sustainability of the funds.
- 3.10 At present, the funds report that administration and investment management costs are £536 million per year, of which £409 million is attributed to investment. Indeed, the reported cost of investment in cash terms has continued to rise in recent years: from £340 million in 2010-11; to £381 million in 2011-12; and £409 million in 2012-13.⁷ In fact, using more detailed and standardised data CEM Benchmarking Incorporated, as sub-contractors to Hymans Robertson, identified that the fees for investment management of the Scheme could be much higher than reported, at in excess of £790 million. Some of the fees for investment management are not fully transparent to the funds and are therefore difficult to quantify. In practice, the actual cost of investment to the funds is likely to be even higher than £790 million, as their analysis did not include other costs in their calculation such as transaction costs and performance related fees on alternative assets.
- 3.11 Coupled with the responses to the call for evidence, Hymans Robertson's analysis has provided a system review, shedding light on the aggregate performance of the Scheme by asset class, as well as the transactions and processes that underpin the

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

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

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

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

Reducing fund costs or tackling deficits?

- 3.13 Although the call for evidence was developed around the primary objectives of reducing fund deficits and improving investment returns, very few responses set out ideas for managing deficits in a different way. The Shadow Scheme Advisory Board argued that more thinking could be done to consider how deficits might be addressed in the longer term. Its sixth recommendation stated⁸:

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

- 3.14 The Government agrees that opportunities to improve funding levels should continue to be explored and looks forward to considering the Shadow Board's proposals for alternative ways of managing deficits. **Respondents to this consultation are also invited to submit any feasible proposals for the reduction of fund deficits.**
- 3.15 While very few submissions effectively tackled deficit reduction, both public and private sector respondents recognised that the Scheme may benefit from addressing the secondary aim of reducing investment costs, partly by managing investments more efficiently. Taking action to reduce the cost of running the Scheme will help to meet this objective by increasing the funding available for investment. In the longer term, this should help to improve the funding level of the Scheme and reduce the pressure on employer contribution rates. This consultation therefore focuses on the cost savings to be found through collaboration and more efficient investment.

Achieving scale to reduce fund costs

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

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

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

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

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

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

Achieving efficiencies and safeguarding local accountability

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

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

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

Costs and benefits of the proposals

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

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

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

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

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

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

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

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

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

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

Local accountability

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

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

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

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

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

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

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

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

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

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

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

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

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

4. Proposals for reform

Proposal 1: Common investment vehicles

The case for change

- 4.1 Using common or collective investment vehicles to aggregate the Scheme's investments and moving to passive investment of listed assets has the potential to deliver significant savings of over £660 million per year, through reduced investment and other costs for all asset classes in the Scheme. These savings were set out by Hymans Robertson, whose report showed that it was likely that the economies of scale from aggregation would be best accessed through common investment vehicles.
- 4.2 Further savings arise from the efficient structure offered by a common investment vehicle. Within any common investment vehicle or pooled fund, money will flow in and out as investors purchase and redeem units in the fund. If those buying and selling units within a pool can be matched, fund managers will not need to sell assets to meet redemption requests and as such the volume of transactions can be minimised, improving cost efficiency.
- 4.3 Common investment vehicles may also deliver savings by reducing the use of "fund of funds" to access alternative assets, such as hedge funds, private equity, property and infrastructure. Fund of funds are used to achieve the scale required for individual funds to make investments they may not be able to access directly. However, this introduces an additional layer of fees, increasing the total cost of investment. Setting up a common investment vehicle would help funds achieve the scale required to invest, without the high costs associated with a "fund of funds".
- 4.4 Hymans Robertson found that investment fees for alternative assets were particularly high compared to other asset classes, accounting for less than 10 per cent of the Scheme's assets, but for at least 40 per cent of fees.¹³ The firm's analysis showed that savings of up to £240 million per year could be achieved by ending the use of "fund of funds" across the Scheme, provided that the existing contracts were permitted to run their full course in order to avoid potentially significant termination costs. Consequently, although some savings would begin to accrue straight away, this annual total would be reached over 10 years.¹⁴
- 4.5 The wider benefits of common investment vehicles include improved transparency. As the funds would be subject to the same investment costs and asset managers, the effect of asset allocation and local decision making would become more transparent, revealed in part by the variation in investment returns. This should provide the Department, fund authorities and taxpayers with an opportunity to compare the effectiveness of a fund's asset allocation. In addition, the vehicle could provide a platform for the operation of national framework agreements, helping to minimise the cost of procurement and other administrative costs of investment such as actuarial and custodial services.

¹³ Local Government Pension Scheme structure analysis; Hymans Robertson p.11

¹⁴ Local Government Pension Scheme structure analysis; Hymans Robertson p.7

- 4.6 A common investment vehicle for alternative assets could also help to improve governance by providing an independent assessment of alternative investment strategies, particularly for local infrastructure investment. A pooled vehicle could make it easier for funds to invest in infrastructure when appropriate opportunities arise, by providing a cost effective way to realise the scale needed.
- 4.7 As discussed in paragraph 3.28, local determination of a fund's asset allocation was seen as a vital consideration amongst respondents to the call for evidence. A common investment vehicle could be designed to allow asset allocation to remain at local fund authority level, consistent with ensuring that decisions are taken in line with existing local accountabilities.

Proposal for reform

- 4.8 The Government believes that there are clear advantages to funds in pooling their assets in common investment vehicles for all asset classes, but that all asset allocation decisions should remain with the fund authorities.
- 4.9 Hymans Robertson's analysis demonstrated that there were slightly higher returns over ten years if the funds were organised through one common investment vehicle for listed assets and a second for alternatives, rather than a greater number. This evidence suggests that savings will be maximised by the creation of two vehicles: a single common investment vehicle for listed assets organised by asset class (for example, UK equity, European equity, UK bonds and so on), and a second vehicle for alternative assets.
- 4.10 Concentrating the Scheme into two common investment vehicles may increase its exposure to risk. Several public and private sector responses to the call for evidence also stressed that capacity constraints may begin to apply if a fund became too large. As one fund authority stated in their response to the call for evidence:

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

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

- Q1. Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Please explain and evidence your view.**
- Q2. Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?**
- Q3. How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?**

Further considerations

A. Changes to the investment regulations

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

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

B. The type of common investment vehicle

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

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

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

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

Proposal 2: Passive fund management of listed assets

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

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

¹⁵ More information can be found on the Financial Conduct Authority's website:

<http://www.fca.org.uk/firms/firm-types/collective-investment-schemes/authorised-contractual-schemes>

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

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

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

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

4.18 However, Hymans Robertson cite evidence from defined benefit pensions funds in the United States which shows that for equities, returns are explained predominantly by market movements and asset allocation policy, with active management playing no role¹⁶.

The case for change

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

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

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

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

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

Extra cost (per annum) of active	0.34*	0.27	0.20	n/a	0.49	0.53
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- 4.21 This analysis of investment return is specific to the performance of the Local Government Pension Scheme in aggregate.
- 4.22 In their report, Hymans Robertson quantified the fees savings achievable from moving to passive management of listed assets as £230 million per annum, assuming that all funds participated.¹⁸
- 4.23 In addition to the savings arising from lower fees, a move to passive management will also reduce the level of asset turnover. This occurs as investment managers buy and sell assets within an asset class. Both passive and active managers buy and sell assets, but turnover is generally much higher, and therefore more costly, under active management. Hymans Robertson estimated that if all of the Scheme's UK and overseas equities had been managed passively in the financial year 2012-13, turnover costs would have been around £190 million lower.¹⁹
- 4.24 Hymans Robertson also conducted a detailed analysis of the transition methodology and costs to move to passive management of all listed assets. They identified that the cost of transition could be around £215 million.²⁰ These transition costs are approximately equal to the savings achieved from reduced turnover costs in just one year.
- 4.25 Their analysis of transition also concluded that any market disruption will be limited as there is no proposed change to asset allocation. Hymans Robertson suggested that a single coordinated but phased transition would minimise market impact.

Proposals for reform

- 4.26 The Hymans Robertson report concluded that if the Scheme acts collectively and moves all listed assets into passive management, investment fees and turnover costs could be reduced by up to £420 million per year. This represents a significant saving for the funds, employers and local taxpayers which would begin to accrue within two years of moving to passive management of listed assets.
- 4.27 Having considered this analysis, the Government believes that funds should make greater use of passive management for all listed assets such as bonds and equities. Alternative assets such as property, infrastructure or private equity would continue to be managed actively through a separate common investment vehicle.

Further consideration

A. Take up of passive management

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

¹⁸ Local Government Pension Scheme structure analysis; Hymans Robertson p.7

¹⁹ Local Government Pension Scheme structure analysis; Hymans Robertson p.7

²⁰ Local Government Pension Scheme structure analysis; Hymans Robertson p.17

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

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

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

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

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

5. Additional considerations

Data transparency

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

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

- 5.2 Moving to a common investment vehicle will help to facilitate this transparency, as the investment fees derived from a common vehicle will be more comparable. It will also help to highlight the effect of asset allocation and fund decision making. Since the funds would be investing through the same vehicles, the effect of asset allocation will be more easily seen from the resulting variation in investment returns. The common investment vehicles would also allow greater clarity over variations between asset allocations and actuarial discount rates.
- 5.3 However, it is clear that further improvements are needed to ensure published Scheme data is comparable between funds. The Minister for Local Government has asked the Shadow Board to look at data transparency in more detail and it has already made progress in this area, bringing together all of the funds' annual reports on its website. The Government is keen to support the Shadow Board in this work and looks forward to working with it to ensure more comparable data is available in the future.

Procurement frameworks

- 5.4 As set out in paragraph 3.24, there are clear advantages and savings to making use of the National LGPS Frameworks. The frameworks provide funds with the opportunity to reduce the cost and time associated with procurement. By developing a short list of approved candidates, the frameworks can help funds reduce the time taken to procure a service from six to nine months to a matter of weeks, as well as offering standardised terms and conditions. In addition to offering savings to the funds, the small fee paid by funds to access the framework helps to ensure that the model is self-financing in the long term.
- 5.5 At present, frameworks have been established by the National LGPS Framework for investment consultancy, global custody and benefit and actuarial services. The Government believes that funds can deliver further savings, using these frameworks to procure a range of services including actuarial and investment advice. Funds should give serious consideration to making greater use of these frameworks. In addition, common investment vehicles could be used as a platform from which to operate such frameworks.

Administration

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

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

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

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