CIPFA The Chartered Institute of Public Finance & Accountancy
3 Robert Street, London WC2N 6RL
T: 020 7543 5600 F: 020 7543 5700
cipfa.org.uk

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Victoria Edwards
Department for Communities and Local Government
Zone 5/F5
Eland House
Bressenden Place
London
SW1E 5DU

Dear Victoria

Future structure of the Local Government Pension Scheme – Call for Evidence

Further to the paper issued on 20 June 2013, in which the department sought evidence regarding the future structure of the LGPS, CIPFA is pleased to offer the following observations.

CIPFA is committed to developing and supporting the highest standards of public financial management and is fully supportive of the need to seek out efficiency in the use of public funds. As you know, CIPFA, via the Pensions Panel, has over many years supported LGPS practitioners in the efficient and effective administration of the LGPS and has more recently has supported efforts to improve efficiency through collaborative working, smarter procurement etc as set out in our 2012 publication *Buying Time*, with Panel members taking the lead in developing national procurement frameworks. The Call for Evidence is a welcome next step in investigating how the administration of the LGPS might be delivered in the future in what we see as an on-going process to improve the efficiency and effectiveness of LGPS operations across all LGPS administering authorities funds. To that end, CIPFA is committed to working with all chief finance officers, practitioners and the LGPS Scheme Advisory Board toward achieving that objective.

Undoubtedly the Call for Evidence will generate a wide range of opinions on this issue and, hopefully, with that a substantial evidence base upon which to form proposals for the future. We thought therefore that it might be helpful to set out some principles that should underpin how DCLG takes forward the next stage of this process, with a view to coming forward with proposals that practitioners can actively engage with.

1. The objectives of reform should be clearly set out

The paper issued on 20 June set out 2 primary and 6 secondary objectives when considering the objectives for structural reform:

High level objectives

1. Dealing with deficits
2. Improving investment returns

Secondary objectives

1. To reduce investment fees
2. To improve the flexibility of investment strategies
3. To provide for greater investment in infrastructure
4. To improve the cost effectiveness of administration
5. To provide access to higher quality staffing resources
6. To provide more in-house investment resource

These are all potentially valid objectives for the LGPS. However we would question whether these should necessarily be linked to structural reform.

Many of these objectives can be, and are being, work towards without recourse to structural reforms. We would also note that in some instances these objectives may be potentially contradictory.

Overall we have concluded that these objectives lack the necessary clarity to form the focus of any reform of the LGPS and fail to identify any outcome that can purely be achieved through structural reform. Our detailed comments are set out below.

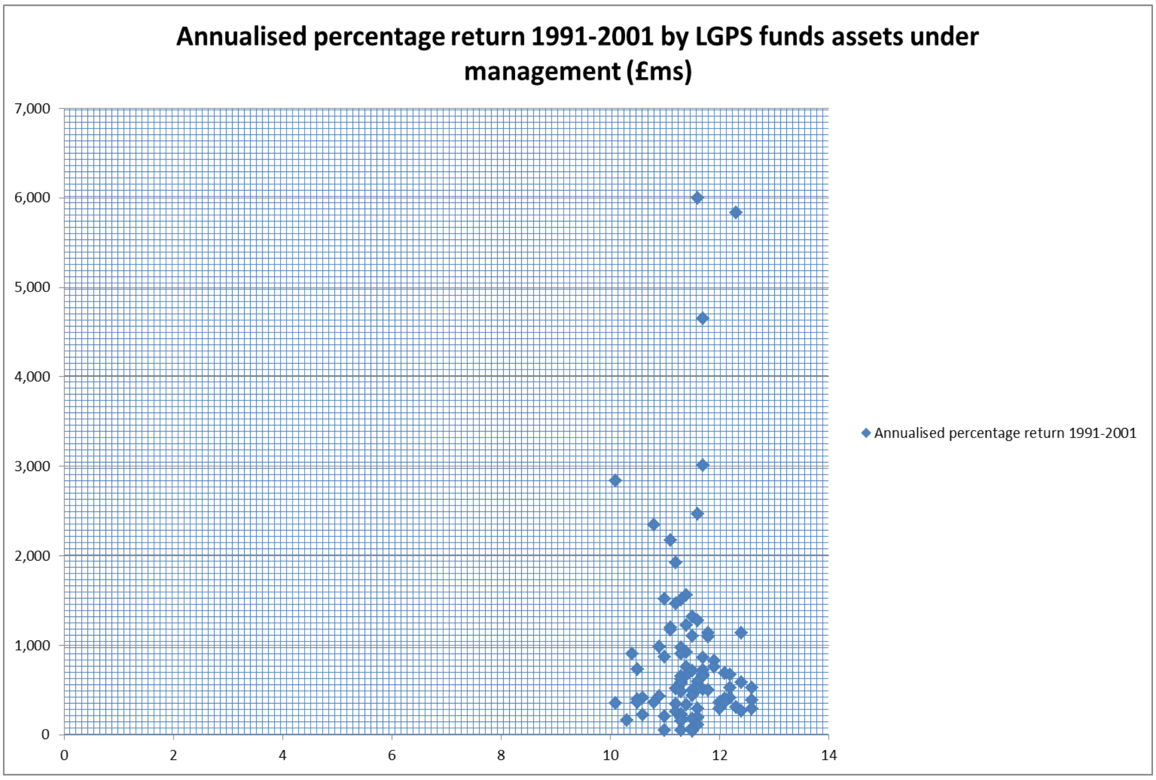
Deficit reduction

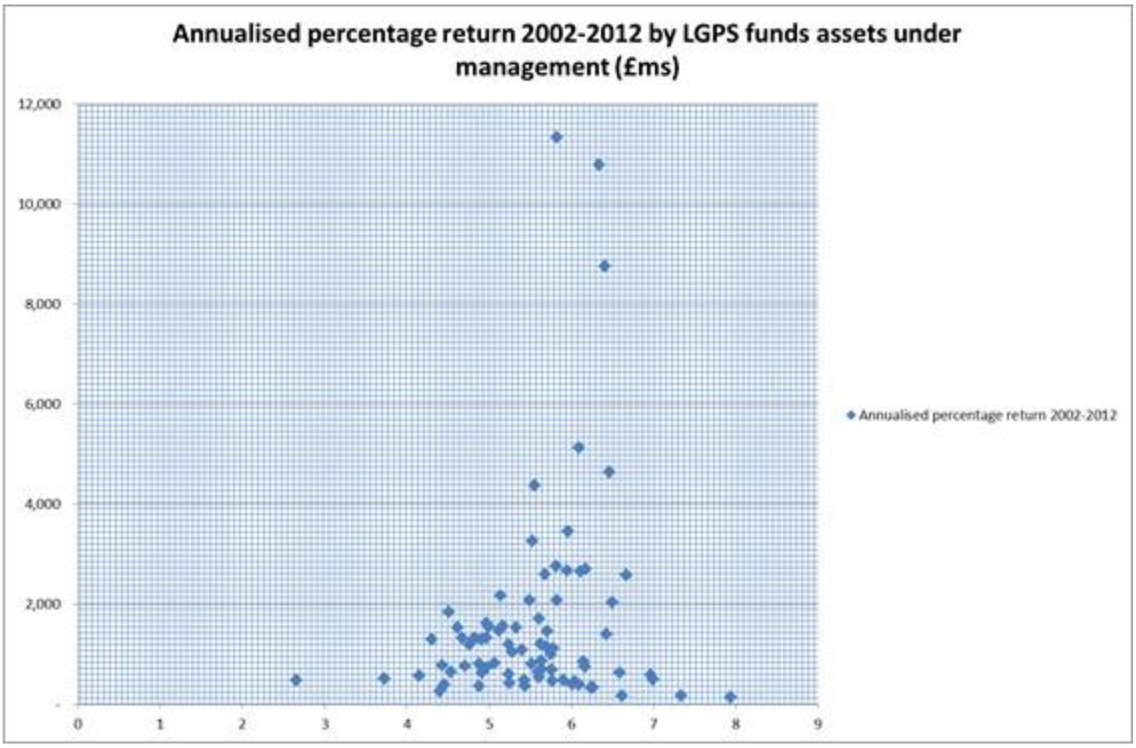
Scheme deficits are a function of the imbalance between assets and liabilities. Reform of the way in which the administration of the LGPS is delivered will not have any significant bearing on scheme liabilities. Nor will it have any impact on employer and employer contributions, which represent the bulk of the asset growth (averaging over 60% of the total in recent years) in funds. Whilst improving investment returns (objective 2) may have some impact on the deficit position, the primary means of deficit reduction would have to come through increasing scheme assets from contributions or reducing scheme liabilities through scheme reform. Also as we note below, it is debatable as to whether structural reform will improve investment returns.

Improving investment returns

One of the main arguments being made in favour of structural reform is that larger funds will generate better investment returns. However the evidence to support this assertion remains inconclusive. Certainly in the case of the LGPS, analysis of the last 2 decades of fund results shows no strong correlation between fund size and investment performance.

The charts below show the annual investment returns achieved by LGPS funds by fund size. The strong grouping around the average, particularly for the decade 1991-2001, indicates that performance does not appear to be affected by fund size, with many smaller funds out-performing larger funds.


Annualised percentage return 1991-2001 by LGPS funds assets under management (£ms)
7,000
6,000
5,000
4,000
3,000
2,000
1,000
0
0
2
4
6
8
10
12
14
Annualised percentage return 1991-2001


Annualised percentage return 2002-2012 by LGPS funds assets under management (£ms)
12,000
10,000
8,000
6,000
4,000
2,000
0
1
2
3
4
5
6
7
8
9
Annualised percentage return 2002-2012

Whilst scale may be a factor in fund performance, this does not appear to be the experience in the LGPS. Clearly there are other factors at work such as investment strategy, appetite for risk, market movements etc which will influence the level of returns that a fund will achieve in any given period. There is no guarantee therefore that simply restructuring funds will improve investment returns.

Reducing investment fees

On the subject of reducing investment fees, care should be taken in focussing purely on the gross amount of fees being paid by funds. Whilst seeking to lower fees in areas where managers are adding little value is clearly desirable, higher fees may be justified where returns or growth can be linked directly to manager performance. Therefore the focus here should be on improving the value for money achieved through the outlay of fees, an objective whose achievement can be assessed using some form of income or growth/fee ratio. This is potentially an area of work that can be tasked to the LGPS Shadow Scheme Advisory Board or its sub-committees.

A further point to regarding this objective is that again its achievement need not necessarily be linked to structural reform. Funds are already keenly aware of the need to get value from their fund manager fees and efforts to secure better value for money have long been the focus of LGPS funds. More recently the development of a Collective Investment Vehicle, which is being taken forward by London funds, will seek to use economies of scale to drive fees down.

Again this is an area of work that can, and is being taken forward without the need for structural reform.

To improve the flexibility of investment strategies

It is not clear from the consultation paper why it is considered that issues of scale impact on the flexibility of investment strategies nor how structural reform will address any such issues. We are not aware of any funds being unduly restricted in their choice of investments as a consequence of their size with many of the smallest LGPS funds being highly diversified into areas such as property, private equity, hedge funds etc.

To provide for greater investment in infrastructure

Again, it is not clear from the consultation how structural reform would help in the pursuit of such an objective. Fund size is not a predominant limiting factor for those funds that wish to pursue infrastructure investment. Rather it is the extent to which funds chose infrastructure as part of their investment strategy that currently limits the extent to which they invest and DCLG has already taken steps in the Investment Regulations to remove a potential barrier to investment by increasing the limit on limited partnership investment to 30%.

Therefore reforming the LGPS structure would not automatically generate any significant increase in infrastructure investment.

To improve the cost effectiveness of administration

Local government is facing funding cuts approaching £9bn per annum by 2015, with further cuts expected beyond that. As set out in CIPFA's statement on the role of the chief financial officer in local government, achieving value for money and securing stewardship are key components of the CFO's role in public service organisations, a duty which is enshrined in legislation for every CFO in local government. In discharging this responsibility, every area of activity is being scrutinized to identify where efficiencies can be made. Pensions administration is no exception.

In the search for greater cost effectiveness in administrative costs, funds are already engaged in a number of initiatives including:

- Local procurement frameworks for legal services, actuarial services, benefits consultancy and investment advisory services

- National frameworks for actuarial services, benefit and investment consultancy, with a national framework for custodian services due to be launched soon (and a further framework for legal services under investigation)

- Developing a collective investment vehicle

- Shared service and outsourcing arrangements for administration

- Joint procurement on scheme information printing, communications etc.

All of these are currently being progressed at minimal cost and without recourse to structural reform.

To provide access to higher quality staffing resources/to provide more in-house investment resource

The aims of "securing higher quality staffing resources" and "more in-house investment resource" are clearly desirable and CIPFA has introduced a Code of Practice on Pension Scheme Finance Knowledge and Skills precisely for the purpose of supporting funds to develop the necessary resources to effectively discharge their responsibilities. However we would again question whether this is an objective that requires structural reform to be achieved.

There are several examples of where administering authorities are building resilience and sharing knowledge and skills through shared service arrangements such as the LGSS (Northamptonshire and Cambridgeshire), the TriBoro (Westminster, Kensington and Chelsea and Hammersmith and Fulham) and Cumbria and Lancashire. All of this has been achieved without the need for structural reform.

The ability of funds to recruit and retain the necessary resources is not necessarily a function of fund size. Access to relevant training, geographical location, legacy local government pay structures that limit salaries and the pressure to drive down administrative costs (as noted above) all play a part in the ability and speed at which funds can improve the quality of their administrative resources.

All of these factors need to be taken into account in the reform agenda.

2. Proposals for the future structure should be based on the best available evidence

There is a great of information on the LGPS that is in the public domain and readily available. However much of it is designed for a specific audience and is not necessarily usable for the purposes of strategic decision-making.

CIPFA has consistently stressed the need for a comprehensive, reliable and robust data set to underpin the type of decision-making necessary to inform structural reform of the LGPS and has separately written to the LGA with our proposals. This includes as a minimum the capture of:

- LGPS scheme administration costs, prepared on a comparable basis.
- Fund management fees incurred by LGPS funds, prepared on a comparable basis.
- Long-term investment performance data for LGPS funds, prepared on a comparable basis and analysed for variations in risk approach and investment strategy.
- Comprehensive valuation data (financial and demographic assumptions, deficit recovery periods etc) to enable fund-by-fund comparison

To accompany such a data collection exercise, DCLG should also consider devising a set of data standards to ensure that accurate fund-by-fund comparisons can be made.

3. Proposals should be subject to rigorous cost/benefit analysis

Prior to the call for evidence, a great deal of the emphasis in the debate on reform of the LGPS has been focussed on the potential cost saving/improved investment performance that might be generated. However too little attention has been paid to the costs associated with structural reforms.

For any future proposals to stand up to scrutiny, they should be subject to thorough cost/benefit analysis that demonstrates the case for change. As we have noted above, ascertaining the potential benefits is far from straightforward, with considerable uncertainty as to whether structural change will, for example, improve investment performance, and if so, to what degree. This introduces considerable risk into any case for change.

What we can say with rather more certainty is that there will be costs involved in structural reforms, proportionate to the scale of reform undertaken.

LGPS resources are already stretched due to cost pressures, the need to implement 2014, auto-enrolment, handling the pensions consequences of wider workforce reductions and work on the various cost-saving measures mentioned earlier. Therefore the ability to divert resources to structural reform from within existing LGPS capacity will be extremely limited and would require significant additional external funding.

The cost/benefit analysis should also take into account that extent to structural reform provides additionality beyond those benefits which might be achieved without recourse to such reform, including the benefits from those initiatives which are already in progress across the LGPS.

I hope these comments are a useful contribution to DCLG's Call for Evidence. As ever, if you would like to discuss further any of the points raised, please do not hesitate to contact CIPFA via the Pensions Panel Secretary, Nigel Keogh, at nigel.keogh@cipfa.org.

Yours sincerely

Bob Summers
Chair, CIPFA Pensions Panel