CIPFA The Chartered Institute of Public Finance & Accountancy

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Dear Victoria

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

Further to the above consultation paper issued on 1 May, in which you sought views on opportunities for collaboration, cost-savings and efficiencies in the LGPS, CIPFA is pleased to offer the following observations.

General 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 2011 publication Buying Time, with Panel members taking the lead in developing national procurement frameworks. Following the earlier Call for Evidence, this further consultation is a welcome next step in investigating how the financial 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.

As requested, responses to your detailed questions are set out in Annex A. In summary our comments are:

- We welcome the fact that these proposals have been designed in such a ways as to allow asset allocation to remain at local fund authority level, which is consistent with ensuring that decisions are taken in line with existing local accountabilities. This principle should underpin any proposals for future development and we are pleased to note that mandated pension funds mergers are not being pursued at this time.

- The development of collective investment schemes are a positive step and could bring benefits through scale, particularly to smaller funds. The work being undertaken by London Councils demonstrates the potential advantages but also highlights the challenges of integrating the structure of the CIV and associated governance arrangement with local accountability and ownership. This is an area that was not fully recognised in the consultation but which will be critical in ensuring the success of CIVs in the LGPS.

  However CIVs should be regarded as just one of a number of options for collaboration. DCLG, working with the Scheme Advisory Board, should seek to assist their development by putting in place the necessary legislation (where required) and the fora through which knowledge, opportunities and best practice can be shared and accessed by all funds. CIVs and other joint working should allowed to evolve as part of the wider closer working initiatives that have developed across the LGPS, rather than seek to limit the number to two and control them from the centre. In particular we would like to see further exploration of the benefits to be derived from in-house management.

- We do not believe that the compulsory use, in whole or in part, of passive management would be in the best long-term interests of the LGPS. Passive management already forms an important part of an LGPS funds investment strategy and the value-for-money benefits should be actively considered alongside other investment options. Funds should be prepared to justify their use of active management and be able to demonstrate the additional benefits that derive from it. More work should also be done to identify best practice in those funds that are performing well and to share this across the LGPS for the benefit of all.

Further considerations

The consultation recognises that the LGPS investment regulations are in need of review and announced the Department's intention to consult separately on reforms to these regulations, including any changes required to facilitate investment in common investment vehicles.

A considerable amount of work has been done in recent years by CIPFA and others to identify and analyse the issues with the current investment regulations and to build a consensus around proposals for their revision. It is the view of the practitioners of the of the Department's Investment Regulations Review Group that reform to the Investment Regulations need not be contingent on the outcome of this consultation and that the proposals developed by the working party, and communicated to the Minister in our letter of 17 February 2014, would deliver a regulatory investment framework which would accommodate the options outlined in the consultation paper. We would suggest therefore that work on this review be expedited not only in preparation for the outcome of this consultation but to allow LGPS funds to more effectively manage their investments as they stand today.

We would also note that whilst we recognise and support the Government's desire for swift implementation of any changes, any implementation timetable must be fully recognise the risks associated with large scale and a comprehensive understanding of the limited resources available and pressures facing local authorities.

Finally, the consultation states that 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. Whilst the emphasis in this consultation is on cost reduction, it is important not to lose sight of this objective. Reducing costs and/or improving returns will only influence the deficit position at the margins and CIPFA is committed to working with the Shadow Scheme Advisory

Board in developing outline proposals that aim to address what is an altogether larger and more complex problem.

As requested, responses to your detailed questions are set out in Annex A.

I hope these comments are a useful contribution to DCLG's consideration of the issues surrounding the future structure of the LGPS. 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

CIPFA, the Chartered Institute of Public Finance and Accountancy, is the professional body for people in public finance. Our 14,000 members work throughout the public services, in national audit agencies, in major accountancy firms, and in other bodies where public money needs to be effectively and efficiently managed.

As the world's only professional accountancy body to specialise in public services, CIPFA's portfolio of qualifications are the foundation for a career in public finance. They include the benchmark professional qualification for public sector accountants as well as a postgraduate diploma for people already working in leadership positions. They are taught by our in-house CIPFA Education and Training Centre as well as other places of learning around the world.

We also champion high performance in public services, translating our experience and insight into clear advice and practical services. They include information and guidance, courses and conferences, property and asset management solutions, consultancy and interim people for a range of public sector clients.

Globally, CIPFA shows the way in public finance by standing up for sound public financial management and good governance. We work with donors, partner governments, accountancy bodies and the public sector around the world to advance public finance and support better public services.

Annex A

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 agree that, in principle, the use of collective investment vehicles will allow some funds to benefit from economies of scale to assist in reducing the cost of investment management and related services, particularly smaller funds. The work done to date by London Councils on developing a collective investment vehicle estimates that combined savings and improved investment return from using the CIV could reach up to £112 million per annum (assuming 100% participation by London boroughs). This chimes with the conclusions in the Hymans Robertson report, which are repeated in the consultation paper, that achieving scale in investments will reduce management costs.

However CIVs are just one potential form of collaboration that can be used to bring about greater cost efficiency in LGPS administration.

Collaborative procurement of services: the LGPS National Frameworks for actuarial services, benefit consultancy, investment advisors and global custody services are already delivering significant savings, with funds set to save on average £1.5m over the term of the contract for global custody services alone.

Co-investment: LGPS funds can work together and with other bodies undertake investment in areas where acting individually would not be as cost-effective. Recent examples include the M8 motorway project which is being financed by a £350m loan provided jointly by the European Investment Bank, Allianz and the GEC Pension Fund. In Denmark, Danish pension funds and the government will invest in a state fund to finance projects to combat climate change in developing countries. PensionDanmark, pension funds PKA and PBU, private investment fund Dansk Vækstkapital, the Investment Fund for Developing Countries, the Danish government and private investors are coming together to create a fund of £180 million which is expected to return 12% per annum.

Collaborative in-house management: The consultation paper has seemingly overlooked the strong evidence provided during the 2013 Call for Evidence with regard to the cost-effectiveness of in-house management and how this might be used to benefit a wider range of funds.

Evidence from State Street Global Services demonstrates that the six LGPS funds which are predominantly in-house managed enjoy significantly lower running costs, up to two thirds less than externally managed funds. At the same time, those funds have also outperformed externally managed funds consistently over the last 25 years by 0.3% per annum.

Analysis of the funds suggests that the lower costs result from a number of factors:

- High cost of external management and associated support services (e.g. manager selection and evaluation) compared to in-house staff salaries, which are contained within normal local government pay arrangements.
- Lower stock turnover -the average holding period of a stock in the East Riding fund for example is 7 seven years (around 3 times longer than in an externally managed fund), therefore fewer transaction costs
- Funds do not suffer the costs of change (transition management) to the same extent as externally managed funds

There are a number of ways in which LGPS funds that are predominantly externally managed could benefit from the experience of their internally managed counterparts.

Administering authorities have the power under Section 101(1)(b) Local Government Act 1972 to delegate functions to another local authority. Using this power, some or all of one funds investment function could be undertaken by another administering authority. There is no requirement to create a complex CIV structure for this to occur.
The in-house investment team of one authority would therefore be able to act for other funds thereby providing the cost advantages of in-house investment and avoiding the need to external manager selection (although the issue as to whether FCA registration of the authority to whom functions would be delegated is mandatory needs to be clarified definitively. In any event, such registration would provide a level of assurance to the delegating authority and would be regarded as good risk management practice). This could be particularly beneficial for those asset classes where external management fees are particularly high (private equity, hedge funds etc).

At the other end of the scale, internally managed funds could act as mentors/trainers for funds wishing to develop their own in-house capability as an alternative to external management, facilitated by the DCLG, Scheme Advisory Board and CIPFA. Over time, this, would allow funds to develop the necessary knowledge, skills and governance capacity over time to take asset management in-house and reduce external costs.

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

We welcome the fact that these proposals have been designed in such a ways as to allow asset allocation to remain at local fund authority level, which is consistent with ensuring that decisions are taken in line with existing local accountabilities.

There is a clear chain of accountability between the administering authority and the elected members that make up those charged with the governance and decision-making in an LGPS fund on the one hand, and the local electorate (from whence the majority of LGPS participating employers draw their funding) on the other. The public availability of committee minutes and the requirement to publish an annual report on pension fund activity enable stakeholders to scrutinise the actions of decision-makers and hold them to account for those actions.

Removing responsibility for setting investment strategy and associated asset allocation (and with it the accountability for the impact of decisions on scheme employers and beneficiaries) away from individual LGPS fund administrators, and into the hands of a third party would represent a major shift in the governance of local authority pensions and would weaken that important democratic link.

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?

As noted above, we agree with the principle that the use of collective investment vehicles has the potential deliver economies of scale to the LGPS, particularly to smaller funds who may not be able to access the lower fee rates achieved by larger funds. They also offer the opportunity to strengthen governance by pooling scarce skilled management and decision-making resources whilst leaving investment strategy and asset allocation decisions with the individual fund authorities.

However we remain concerned that the paper proposes limiting the use of collective investments to just 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)

- a single vehicle for alternative assets.

Risk is an inevitable and unavoidable feature of LGPS investments. There are systemic risks which arise from the possibility of an interlinked and simultaneous failure of several asset classes and/or investment managers, possibly compounded by financial 'contagion', resulting in an increase in the cost of meeting pension fund liabilities.

Pension fund committees mitigate these risks by being aware of key concentrations among the assets they hold and the impact of potential setbacks in asset prices, and diversify their portfolios accordingly. Similarly they understand the impact upon pension fund returns that can arise from manager underperformance and combine active and passive management within their investment structure, and use several active managers, to lessen the impact should significant manager underperformance occur (this also diversifies the benefits of any active manager's outperformance but appropriate diversification is widely regarded as good investment discipline).

When one looks at the LGPS as a whole, the exposure to these types of risks is further diluted, as not all funds are diversified in the same way. Nor do they all use the same managers, at the same time. At any given point in time, LGPS assets under external management will be spread over 150+ different managers.

Whilst the use of a single vehicle with sub-funds for different asset classes will not necessarily increase portfolio diversification risk, it will concentrate manager underperformance risk across a far smaller pool of managers than the LGPS employs at present, as a collective investment vehicle is unlikely to engage with such a broad range of managers if it is achieve the economies of scale it is supposed to achieve.

Supporting the development of multiple collective investment vehicles would help to avoid concentration of manager risk. If developed on a regional basis it would also allow the governance of those vehicles to be developed upon the back of existing regional governance structures, maintaining a local identity to the vehicle which could prove valuable in attracting investors. This could be achieved through the use of existing joint committee structures such as SIGOMA (Special Interest Group of Metropolitan Authorities) which contains 5 of the largest LGPS administering authorities, a sub-committee of the County Councils Network or bodies such as London Councils, which is leading on the London CIV, and has established a joint committee to take forward work on the CIV.

We would also refer back to the comments made in response to Question 1 that the use of CIVs is only one route to greater collaboration between funds and that all potential models should remain open to LGPS funds to explore. A more diversified approach to collaborative working would assist in avoiding the over-concentration of assets referred to above.

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

As the consultation paper points out, there are a number of types of common investment vehicle available that might be used in the LGPS. The Hymans Robertson report identifies Unit Trusts, Open Ended Investment Companies (OEICs), Limited Partnerships (LP), Authorised Contractual Schemes (ACS) and Unit Linked Life Funds as five examples of vehicles that might be set up which could be tailored to LGPS funds.

The paper helpfully sets out a number of principles that should underpin the choice of vehicle/s. It/they should allow for:

- 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.

We agree with this assessment. Any collective investment vehicle used by LGPS funds should meet the same regulatory criteria as existing investment types as set out in the LGPS investment regulations. This would offer the necessary assurance to potential investors.

In our view, creating the right governance structure around collective investment vehicles will be as important to their success in attracting investors as offering value for money. We suggest that the governance structure/s of collective investment vehicles should be built around the following principles:

- Flexible – the governance model should be structured in such a way as to allow full participation in key decision-making of all investors. A closed model that excludes investors from, for example, manager selection, may affect investor buy-in to collective arrangements.
- Skilled – participants in the governance structure should possess the appropriate knowledge and skills to undertake the role (the CIPFA Knowledge and Skills Framework for Elected Representatives and Non-executives in the Public Sector is cited as an example of the necessary knowledge and skill levels)
- Transparent – the activities of the governance body should be open and transparent to all LGPS stakeholders, with records of meetings etc made publically available. That transparency should also extend to the ability of stakeholders of individual funds to “look-through” the vehicle to the investments in which their fund is invested.

We would also refer back to the comments made in response to Question 1 that the use of CIVs is only one route to greater collaboration between funds and that all potential models should remain open to LGPS funds to explore.

Q5. 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.**

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?

We agree that the aims of this consultation are sound and that securing value for money must include improving value for money in investment management costs. However it is important to recognise that simply reducing cost does not necessarily equate to improving value for money.

Active management delivering value for money

It is undoubtedly the case that passive management can be delivered at lower cost than active management. However we would challenge the assumption in the consultation that in the long-term, active management does not deliver value for money for the additional cost.

The review period considered in the Hymans report is confined to the last 10 years of LGPS fund performance. Ten years is a relatively short timescale to form a judgement on an active pension fund which is looking to an 80+ year horizon and can be unrepresentative of longer-term fund performance.

For example, if you were to take the previous 10 year period as the reference point (1994-2004), a similar analysis of UK equity performance would show that whilst the FTSE 100 index grew by on average 5.6% per annum, LGPS fund UK equities returned on average 6.9% per annum, significantly outperforming the index. Had funds been constrained to passive-only mandates during this period, they would have foregone almost 20% of the returns generated over this period. Had the analysis been based on this time period, no doubt very different conclusions would have been reached.

It should also be noted that the reference period includes the most turbulent period in financial markets in the history of the LGPS, which again is atypical of the longer-term picture.

Limiting options

The consultation states that "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." Whilst taking action to reduce the cost of running the Scheme will contribute towards meeting this objective by increasing the funding available for investment, it is unlikely in itself to be sufficient to address deficits.

In order to effectively consider measures to address deficits, funds and the Shadow Board should have at their disposal the widest range of tools possible. Cutting off access to active management investment removes one off the few tools to help reduce deficits and further limits options available to manage deficits effectively by seeking ways in which to grow assets at a faster pace than liabilities are rising.

Aggregate data hides good practice

The consultation concludes that, based on the Hymans report, in aggregate the performance of LGPS funds over the last ten years is on or about the index and therefore a shift to passive should not have a detrimental impact on overall LGPS performance. However in looking only at aggregate performance, this consultation paper overlooks the fact that many funds are regularly out-performing the index.

Mandating “passive-only” investment not only penalises those funds that have performed well but would be a missed opportunity to understand why those funds have been successful, why others have been less successful, and how lessons can be learned to help all funds achieve a better level of performance.

Another downside to looking at the LGPS in aggregate is that it fails to recognise that the wide variance in the current asset allocation of funds. Should a move to passive investment (whatever that entails) be mandated, each fund will have a different starting point and a different route to compliance with different timescales and complications to reach the required position. This adds complexity (and potentially cost) and is not helpful in gaining consistency for the LGPS.

The principle of local accountability

The consultation paper recognises that “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.” Our response to Question 2 above reinforces this point.

Any move to increase the extent to which asset allocation is determined centrally (such as mandating “passive only” or stipulating a fixed percentage of funds be invested in passively) would only serve to dilute local accountability and weaken the local democratic link whereby local stakeholders can hold local elected representatives to account.

Understanding what is meant by “passive” investment

In addition to the points outlined above, there are practical issues with mandating “passive” only investment.

Under the umbrella term “passive management” are a variety of techniques ranging from strategies that do not employ stocking picking or sales timing, to matching a stock portfolio to a particular index, to simply selecting stock to hold on a long-term basis, without active monitoring or trading. It could also be extended to encompass strategies such as smart beta (or advanced beta, alternative beta or passive plus). Such strategies avoid conventional market capitalisation weights to seek a better risk and return trade-off by using alternative weighting schemes based on measures such as volatility or dividends.

It is unclear from the consultation paper what type of passive management is preferred. This in turn raises issues of adequately defining what is meant by passive management in regulation, which would add further uncertainty to the LGPS investment regulations.

Unintended consequences

There are a number of potential unintended consequences that might arise from these proposals that are not fully considered in the consultation paper. For example:

- Will compulsion into passive management drive funds to reduce overall equity exposure in favour other return-seeking assets?

- Will compulsion negatively modify fund behaviour and approach to risk?

- Would compulsion constitute the imposition of unrewarded financial risk upon funds (for example the risk that better returns could have been achieved under active management)?

- How will successfully performing funds account for any deterioration in fund performance as a consequence of a compulsory switch to passive to their stakeholders?

- Under normal market conditions, investors will seek to apply capital where rewards are commensurate with acceptable risk, according to their own risk appetite/budget. Mandating funds to passive-only investment, whilst potentially reducing investment costs, artificially distorts this allocation process. Is restricting the flow of capital in this way in the wider best interests of the UK's financial markets?

These are all issues that should be thought through when considering the various proposals in the consultation paper.

Conclusions

It is our view that passive management already forms an important part of an LGPS funds investment strategy and the value-for-money benefits should be actively considered alongside other investment options. Funds should be prepared to justify their use of active management and be able to demonstrate the additional benefits that derive from it. The recently published CIPFA guidance on accounting for LGPS management costs and the work CIPFA is doing with the Shadow Board on comparable data through our benchmarking services and extensive network of CFO and practitioner contacts will help to identify costs more accurately and enable clearer links to be established between investment management cost and performance. More work should also be done to identify best practice in those funds that are performing well and to share this across the LGPS for the benefit of all. However, for the reasons outlined above, we do not believe that compulsion, in whole or in part would be in the best long-term interests of the LGPS.