

# The changing landscape for the Local Government Pension Scheme

## *How can managers respond?*



## Introduction

It is well understood that the most significant influences on the financial health of pension schemes relate to benefit levels, contribution rates, longevity experience and the choice of investment strategy. As such it is understandable that there has been a focus over the past couple of years on the design of the Local Government Pension Schemes (LGPS), covering benefit levels and contributions amongst other things.

Turning to the investment arrangements of a pension scheme, reducing the fees paid to your investment managers or increasing the returns earned by your managers are not going to fundamentally change the funding status of any scheme, but in combination with other measures, they can help. A scheme's chosen investment strategy, however, does have a fundamental impact on funding health, and there are steps that the LGPS can take to increase the chances of being able to execute changes in a fund's chosen strategic asset allocation in a positive way.

Before we discuss how the investment manager community can help in this dynamic, we set the scene for the current status of the LGPS.

## Full Funding

### The Numbers

The term full-funding can be somewhat misleading; in reality the LGPS has rarely enjoyed the funding position required to pay the pensions of its members. For example the 2007 actuarial valuation revealed a funding deficit of GBP 42bn. As LGPS benefits are paid out over many years there is little short term pressure to achieve a 100% funding level. Furthermore strong economic growth, net positive investment returns and a public sector workforce which grew substantially under the Labour Government between 1999 and 2008 ensured a net positive cash flow which mitigated any risk of a benefit shortfall.

### Solvency

The pressure on private sector pension schemes to achieve full funding stems from the risk of insolvency from the sponsoring company. The fundamental consideration is protection; the retirement provision of members must be protected from the parent company becoming insolvent.

By contrast the public sector pension scheme is underwritten by the government which in reality can never become insolvent; the management of public sector scheme will therefore be fundamentally different to that of private sector schemes.<sup>1</sup>

### Liabilities

Clearly then the benchmark for effective management of public sector schemes is uniquely different from that of private sector schemes. LGPS are still open and receiving contributions while the government deficit protection means that there is little short term pressure to meet liabilities. So why is there a concern over the results of the 2013 valuation?

<sup>1</sup> New Local Government Network, Room-to-Manoeuvre, Dr David Chapman and Tom Symons, 2010

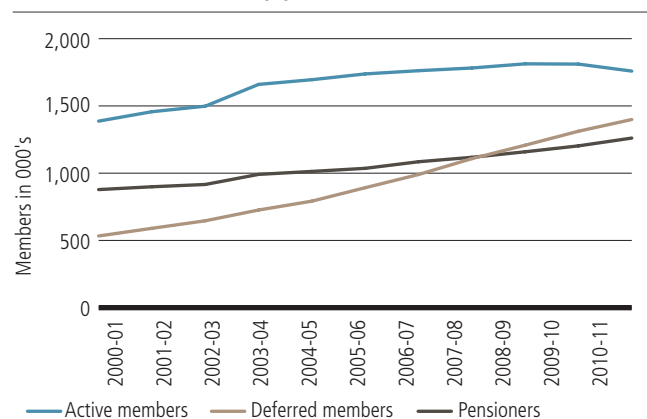
<sup>2</sup> The Chartered Institute for Personnel and Development, 2012

## The Changing Landscape

### Decreasing Contributions

The Office for Budget Responsibility 2012 report estimated that the public sector workforce would shrink by 710,000 by 2017. This would effectively take the size of the state sector to its lowest level since the creation of the welfare state after the Second World War and is a result of direct job losses, outsourcing and early retirement. Exacerbating the reduction in contributions, many members have opted out in order to top up their monthly income; thus further reducing inflows into the scheme<sup>2</sup>.

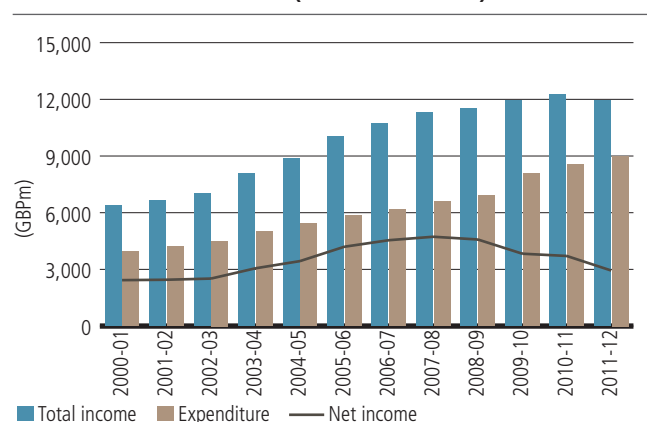
Chart 1: LGPS membership profile (2001 – 2011)



Source: Local Government Chronicle, 24 November 2011

The effect on the financial position of LGPS is dramatic. Employee contributions peaked in 2009-10 at GBP 2bn but then fell back in 2010-11. The result of this overall decline in contributions from employees has contributed to the decline in the net cash flow of the scheme. The Chartered Institute for Public Finance and Accounting estimate the figure to a 20% drop over the last two years, a trend which is likely to continue.

Chart 2: LGPS net cash flow (2000-01 – 2010-11)



Source: Local Government Chronicle, 24 November 2011

### *Changing Demographic*

These monetary constraints are compounded by the increasing life-expectancy of the UK workforce. The UK has witnessed a dramatic rise in life expectancy with which has increased by 4.2 years to 79.9 years from 1990 to 2010.<sup>3</sup> Of course this should be viewed as good news, however it is estimated that an extra year of life for a retired person typically means a pension scheme must increase its stock of assets by 3% to 4% to generate the extra income required to meet these liabilities.<sup>4</sup>

### *Lower Returns*

Unsurprisingly the financial crisis has also had a negative impact on the investment performance of LGPS. In the five year period to the end of 2012, LGPS underperformed the long-term return target assumed on their assets on average by 2.8%.<sup>5</sup> Furthermore, LGPS on average underperformed their peers on the corporate pension side by 0.8% over the same period.<sup>6</sup> Although this statistic on its own does not prove anything (as this could be explained by the higher bond content on the corporate side and the effects on bond yields of quantitative easing), it has been used as an argument for weaker decision making within LGPS compared to corporate schemes.

### *History*

History must also bear some responsibility for the current deficit levels. During the 1980's a number of council's undertook a contributions holiday which was advocated by central Government. Budget cuts in the 1990's then saw a funding level of 75% set, effectively allowing pension scheme members to accrue benefits without making the necessary contributions to meet these liabilities. The current deficit pressure is partly due to these members reaching retirement age and drawing their pensions.<sup>7</sup>

### *Political Pressure*

The result of these factors has culminated in growing pressure from Whitehall and central government. The 2011 report by Lord Hutton contended that LGPS procured services inefficiently leading to inflated pricing by service providers and the increasing deficit made LGPS very costly to the taxpayer. For example, the gap between contributions and payments is set to reach £9.7 billion by 2014-15.<sup>8</sup> Hutton stated that in order to overcome these challenges the bureaucratic and opaque LGPS must reform.

## ***“Shake-up for Local Authority pensions schemes.”***

Public Finance, 26 April 2013

### **The Response**

Understandably this situation is not going unnoticed and both local and central government are positioning themselves for a potential change to help address these issues.

LGPS have therefore found themselves in the difficult position of having to recover the pension scheme deficit, demonstrate their ability to work more collaboratively whilst simultaneously reducing costs.

To overcome these challenges some schemes have pooled their resources and established framework agreements. These agreements allow schemes to pool resources in order to select the best suited services for their needs and have become most common in the areas of consulting and actuarial expertise. Other LGPS have taken the concept further and have established frameworks focused on investment management products, for example.

Framework agreements can create competition between providers which can help drive down costs. Equally, investment management fund panels (which are where single schemes “pre-approve” a short-list of managers to allow easy switching between them in the future) in particular can alleviate the need to continuously navigate the Official Journal of the European Union (OJEU) process should a scheme wish to appoint a new manager.

The OJEU process and the resulting challenge for LGPS to react to market opportunities is certainly a factor in their inability to reduce the pension deficit, although this weakness cannot be addressed by an investment manager panel or a framework agreement per se. However the culture of pooling resources can foster best practice; allowing schemes to learn from one another rather than one scheme attempting to become a specialist across all areas of the investment spectrum.

### *Central Government*

As beneficial as these initiatives may be, they have not stopped Central Government investigating the feasibility of merging the 89 locally administered LGPS into larger regional entities. It is argued that to create genuine economies of scale a wholesale restructure of the LGPS landscape is necessary.

Despite the perceived benefits of such an approach, a wholesale or regional merger has numerous challenges, not least political allegiances, questions about accountability and cost savings, a large dispersion between the liability profiles of individual funds and the multi-employer structure of LGPS.

<sup>3</sup> The Lancet, December 2012

<sup>4</sup> BBC News, November 2010

<sup>5</sup> WM Group Universe Results

<sup>6</sup> WM Local Authority Quarterly Review, Q4 2012

<sup>7</sup> New Local Government Network, Room-to-Manoeuvre, Dr David Chapman and Tom Symons, 2010

<sup>8</sup> Michael Jonson, Public Sector Pension: a catastrophe for UK plc

Framework agreements and fund panels offer significant advantages but to maximise the impact of initiatives within the current LGPS structure they must be supplemented with support from the Investment Management community.

### The Role of the Investment Manager

We have referred to the possible involvement of the investment management community in helping to provide a solution to the problems that the LGPS market finds itself in. Whilst there are several relevant aspects of the relationship between funds and their managers that are worth exploring, it is necessary to be realistic and open about the materiality of the help that fund managers can give. Any help should be well received, but some help will have more impact than others. In general, the help that managers can give will have more of an impact from a governance stand point than from a hard cost perspective.

In order of impact (low to high), we believe that there are four levels of assistance that we as a manager community can provide:

- 1.Reducing fund **manager fees** through the use of framework agreements. This can have a particularly material effect if targeted at those asset classes or management approaches where significant scale can be achieved by pooling assets, such as global equities or passive management. This is undoubtedly the area where visible costs can be reduced most significantly. However, compared to the impact of asset allocation and governance on the future solvency position of any pension fund, saving a few basis points on manager fees will not on its own turn-around the future financial health of a pension scheme. Schemes should also remain aware that accessing more specialist alternative strategies may come at a higher price, but they can also play an important role in delivering higher alpha which, cheaper, traditional strategies may not. A secondary benefit here could be achieved through the willingness of managers to tailor their services within such a framework to the unique needs of the LGPS. This may be something simple such as running a mandate that excludes specific stocks / sectors investment, but equally could be more complex.
- 2.Investment managers partnering with LGPS to provide free **value added services** outside of the management of the scheme assets, recognising that LGPS budgets for training etc., are usually limited. Such services are usually targeted at investment training and event sponsorship. Whilst the hard costs saved through such a partnership may not be significant, the benefit of having a better trained investment panel which is better able to make value added investment decisions can be significant, though as with most aspects of governance, difficult to measure.
- 3 **Greater involvement in discussions** around strategy and tactical market opportunities. LGPS can make better use of the stable of investment experts that already have a presence within the scheme arrangements. Either because of entrenched roles (e.g. a consultant advises, a manager implements), or out of habit, we believe there is often a wealth of investment knowledge that goes untapped. This criticism goes both ways – you need a willing audience for these views and the ability to act on them should an opportunity for change be identified, but most importantly you need a manager community that is willing to volunteer investment opinion on subjects outside of their direct mandate in a way that is not just about pushing new product.
4. Facilitating access to new market opportunities through the use of managers with broad **multi-asset capabilities**. By partnering with a manager who can offer a breadth of investment skill sets, funds have the ability to be nimble and efficient in the way in which they change asset allocation over time to take advantage of emerging investment opportunities. By quite some margin this is the mechanism by which we believe that most benefit can be gained. This is not about cost; it is about improving governance and decision making, and aims to help schemes take maximum advantage of investment insight delivered to them through either their managers or their advisors.

Below, we discuss each in turn.

#### 1. Manager Fees

The level of investment manager fees over the past few years has changed, in some cases materially. At a high level, fee changes have been driven by a shift in the type of investment management services purchased by Schemes. Previously, a Scheme may have paid active fees for a modest added value target of +1% per annum across the entire fund. Now, it is more common for a Scheme to “barbell” their manager styles, employing a portion of assets on a passive basis for very low fees (of around 10% of an active fee), with a complementary portion being invested with a higher return target, higher fee manager. The proportion of assets invested in low cost passive versus higher fee active is what has driven changes in fees on a Scheme by Scheme basis.

In order to take advantage of buying power across different schemes, there are many examples in the market of LGPS that have teamed up to offer a Framework agreement. A Framework agreement allows managers to offer a lower fee in exchange for participating in a single selection exercise, the results of which can be enjoyed by a variety of Schemes.

In general terms, it is more practical to consider a Framework Agreement for simple mandates which follow a well defined process, such as passive management or LDI. As there is much less difference in style or approach between managers, it is more likely that a manager that is acceptable to one Scheme will be acceptable to another.

## 2. Value Added Services

For a fund manager to have a successful business within the LGPS sector, specialist knowledge of the pressures and influences that the sector is under is required. Further we believe that the long term nature of the LGPS lends greater opportunities for relationships that are more akin to partnerships than simple client/supplier relationships.

Couple these comments with the fact that a number of the issues the LGPS face centres on their lack of resources, they should therefore consider extracting as much value as they can from the managers on their roster, and managers should be willing to invest in this sector as a quid pro quo.

Many larger multi-product Investment Managers boast an array of tools and expertise which can be of particular benefit for LGPS. These tools may include economic insights and valuable trustee training. This not only improves scheme governance but better equips members with the ability to manage the long term direction of the scheme, ultimately achieving a higher funding ratio.

## 3. Greater involvement in strategic and tactical discussions

Investment managers can take this value-add approach several steps further by playing a greater role in strategic and tactical discussions. For example, as some schemes are already beginning to do, asking your managers to comment on the continuing relevance of your strategic asset allocation in achieving your long term goals on an annual basis would provide a formal framework for capturing input from your managers. Based on the quality and relevance of the responses you get, you will quickly be able to see which investment managers understand the context within which they are providing services to the scheme.

## 4. Accessing Multi-Asset Capability

Finally, we discuss the area of collaboration between the LGPS sector and the manager community that we believe can have the most significant effect on the future financial health of the sector, namely improving access to investment opportunities and asset allocation opportunities that may be difficult and inefficient if done using a conventional

static procurement process. Larger LGPS may have increased buying power, but this will not equip them to access the market with greater ease whilst fund panels and framework agreements can allow smooth access to a defined number of managers, however they tend to be asset class specific. Utilising the expertise of managers who have multi-asset capabilities can allow asset allocation decisions to be made more nimbly across different asset classes.

There are several types of manager services that could fall under this banner, from outsourced multi-manager arrangements within an asset class (which are not popular within LGPS), to full service fiduciary management across multiple asset classes (again, not popular). We would strongly encourage the development of a middle ground which offers the same benefits in terms of improved implementation efficiency and access to new market opportunities, but which is more discrete and relevant to the objectives of the pension scheme.

For example, as more and more schemes move for the first time to a cash-flow negative profile, a manager with a multi-asset income capability may be awarded a portfolio and asked to produce an income of £X million per annum, with some limit around risk. In order to achieve this, the manager can be free to invest in any market opportunity he/she sees as being appropriate, and will be expected to change allocations materially over time.

Other examples could include creating solutions that respond to the challenge of LGPS attempting to reduce the Scheme deficit and manage expenditure in an increasingly regulated environment. A manager may be asked to construct a portfolio designed to more efficiently capture risk premia at a lower cost through alternative indexation strategies. Such a solution could blend indices to lower risk and maximise returns whilst including specific stock exclusions or additional active voting rights. These services within a discrete portfolio are more palatable from a control perspective but still delegates some tactical market decisions to the participant that is closest to the markets.

## Conclusion

The financial health of pension schemes is influenced by a number of structural factors; it is widely accepted that benefit levels, contribution rates and demographic changes are the main drivers of scheme funding levels. The recent attention the design of the LGPS has received reflects these structural forces, though the impact of any re-design remains somewhat unclear. Central to the belief that a solution can be found within the current structure is the improvement of Scheme governance. LGPS have issued their own response to this situation encompassed in fund panel and framework agreements which facilitate best practice. We accept that the investment strategy, returns and fees paid to managers will not fundamentally reduce the LGPS deficit alone. However, we do believe that combining the expertise of the Investment Management community, through better access to investment ideas and improving the knowledge of elected members, can have a material effect on governance and the ability of Schemes to meet the challenges that lie ahead.

# Working in *partnership* with you.

At UBS Global Asset Management we are committed to creating long-term relationships with our clients. Part of this commitment includes hosting our own series of free, Trustee training events as well as publishing educational materials, including our long standing Pension Fund Indicators report and Skills and Knowledge Guide.

If you would like to find out more about our training events or to receive these publications, please contact us directly.



**Gavin Lewis**  
Business Development Director  
+44-20-7901 5472  
gavin.lewis@ubs.com

**This document is for Professional Clients only. It is not to be distributed to or relied upon by Retail Clients under any circumstances.** This document is issued by UBS Global Asset Management (UK) Ltd and is intended for limited distribution to the clients and associates of UBS Global Asset Management. Use or distribution by any other person is prohibited. Copying any part of this publication without the written permission of UBS Global Asset Management is prohibited. Care has been taken to ensure the accuracy of its content, but no responsibility is accepted for any errors or omissions herein. The information in this document should not be considered a recommendation to purchase or sell any particular security and the opinions expressed are those of UBS Global Asset Management and are subject to change without notice. Furthermore, there can be no assurance that any trends described in this document will continue or that forecasts will occur because economic and market conditions change frequently. UBS Global Asset Management (UK) Ltd is a subsidiary of UBS AG. Registered in England and authorised and regulated by the Financial Conduct Authority. Telephone calls may be recorded. © UBS 2013. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved. Issued in July 2013.