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Cumbria County Council

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Dear Victoria

Call for Evidence on the Future Structure of the Local Government Pension Scheme - Response on behalf of Cumbria LGPS

1.1 Cumbria LGPS welcomes the opportunity to respond to the call for evidence on the future structure of the LGPS. While the focus of the questions is very geared towards asset management and governance within the LGPS, emphasis on the liabilities and the management therefore must also be given equal consideration if Schemes are to achieve the desired outcomes of sustainability and affordability to the taxpayer.

1.2 Cumbria LGPS is already actively engaging in many initiatives to improve efficiency and performance and as such is pleased to be able to have its initiatives to date and further views considered on how best these and other measures can be further progressed.

1.3 We also welcome the assurance that all views and supporting evidence will be given equal consideration throughout this process. We anticipate that the review of complete and transparent evidential data will ensure that future changes aimed at enhancing the LGPS are introduced.

1.4 The thinking behind the call for evidence seems to be that a smaller number of larger funds will inevitably pay less and perform better. There is no evidence to support this. Hyman's evidence shows that mandate values at £100m secure the top level fees. Even as a medium sized fund Cumbria LGPS already pays managers' lowest tier of fees due to the size of mandate which it awards and has also been able to negotiate "most favoured nation" terms in its recent contracts which means that it will always pay the manager's lowest fee. While it is accepted that this may not be the case for some of the very small Funds with mandates less than £100m the scale of savings which might be achieved through squeezing managers are insignificant in the context of the real issue which faces LGPS; namely the scale of funds' liabilities and hence the size of the deficit which needs to be addressed, through the delivery of successful investment and liability management strategies.

1.5 Cumbria County Council is the Administration Authority for the Cumbria LGPS in the County of Cumbria. The Cumbria LGPS provides a means of pension saving for nearly 49,000 scheme members (9.8% of the Cumbrian population[I]) and 105 employers ranging from Local Authorities to multi-national companies and small local charities. The Fund had assets at the end of March 2013 of approx £1.7bn and is

[I] Based on mid-2012 estimate:
http://www.cumbriaobservatory.org.uk/elibrary/Content/Internet/536/673/1757/39317171954.pdf

therefore considered of “medium size”, ranking it 35th [I] by this measure out of the 89 Funds in the England and Wales.

1.6 The Fund has a successful record of delivering both savings and service enhancements through collaboration over recent years, including successfully transitioning pensions administration services on a shared service basis to Lancashire County Council; jointly procuring a range of contracts including actuarial services with neighbouring funds; use of frameworks established at both a national and more Fund specific level; actively supporting and benefitting from the extensive LGPS technical support networks run through CIPFA but supported by most Officers in the Funds.

1.7 In answering the questions posed in the call for evidence we start from the proposition that there is no inherent logic or evidence to support the view that says that larger funds perform better than smaller funds, or that small is beautiful. Recent research commissioned by Hymans Roberts specifically to provide comparable data to support this consultation shows “the potential cost savings that would arise from merely merging funds are much less than previous speculation suggested” and that although savings can be achieved in specific areas such as alternative investing, the desired results could potentially be achieved with much less upheaval and no loss of local control through other means such as asset pooling.

1.8 Other analysis has also shown, that size is not necessarily an indicator of investment performance, that the top performing LGPSs include some of the smallest schemes in the Country however so does the list of the worst performing funds. Similarly in investment terms the LPFA Fund, one of the larger funds, has tended to underperform whereas the very large Greater Manchester Fund has performed well. Thus we can read nothing into the size of funds in regards to investment performance. Meanwhile merging of funds will inevitably result in transitional costs including the need to review investment strategies, which would be likely to be costly and detract from performance in the medium term as funds focus on the merger process.

<u>Dealing with the questions in the Call for Evidence in turn</u>

2.0 Question 1 – *How can the Local Government Pension Scheme best achieve a high level of accountability to local taxpayers and other interested parties – including through the availability of transparent and comparable data on costs and income – while adapting to become more efficient and to promote stronger investment performance.*

2.1 To address this it must first be established what the Funds, at a local level, have control over and then to whom should the funds be accountable for the issues to which they have control

2.2 The financial health of pension schemes depends on:

[I] As at 31st March 2012 based on DLCG SF3 data https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/204798/Pension_1112_drop_down.xls

1. Benefit levels and contribution rates - these are set nationally by Government and as such the Schemes locally have no discretion to change these;
2. Actuarial assumptions - these are set by the Scheme appointed independent actuary; and
3. Investment strategy - this is set at a Fund level by the Scheme's Pensions Committee comprising locally elected and accountable Councillors.

2.3 There is an argument that as members directly contribute to their pension and that they are made on a deferred pay basis funds should be accountable to beneficiaries. However as can be seen from the above the pensions benefits and contributions payable from members of the Fund are prescribed nationally and therefore cannot be influenced by local decision making.

2.4 However, given that contributions are partly funded by the taxpayer there should be accountability to the employer who represents the taxpayer. Both are valid and while the focus has been on employers and taxpayers the importance of accountability to beneficiaries must.

2.5 There is potentially a degree of conflict between the overall objectives of the Fund, which are to ensure that resources are available to ensure benefits can be paid, and the desire of employers and taxpayers for reduced contribution rates. The Fund must have regard to the affordability and sustainability of contribution rates, but Funds cannot reach a situation where employers are given some form of veto. as this risks funds being run in an imprudent manner, acting entirely in the best interests of individual scheme employers without due consideration to other scheme participants and beneficiaries.

2.6 Accountability might be thought to mean any combination of the following:

- The ability to influence the level of contribution rates;
- The ability to influence investment strategy and risk appetite; and
- The ability to challenge performance in the fields of both investment and administration.

2.7 So how is accountability best exercised? The publication of information in an accessible and understandable form is central to this and there are already requirements on funds to publish a great deal of information, through for example the Annual Report and Accounts and to formally consult on the production of a range of key policies and strategies.

2.8 The current Governance arrangements within the LGPS, where Pensions Committees are principally comprised of locally elected councillors, provide for the exercise of a high level of accountability to local tax payers and interested parties. Governance compliance statements, prepared by LGPSs confirm that the great majority provide detailed information on performance and activities through the annual reports and other publications. The governance changes proposed as a consequence of the Public Services Pensions Act 2013 will strengthen this.

2.9 These governance arrangements ensure that, within the LGPS, there is a great deal of information publically available. However, as there is discretion in preparing some of the elements of the information making comparisons is difficult. For there to be confidence in the conclusions drawn from any analysis of the data, it is imperative that the basis of the preparation of that data is more prescriptive than at present, and audited, to avoid ambiguities and ensure objectivity.

2.10 Turning to efficiencies, these are already flowing from collaborative working between Funds, Cumbria included, as outlined above (para. 1.6). This was recognised by Lord Hutton in his report – "Central and local government should closely monitor the benefits associated with the current co-operative projects within the LGPS, with a view to encouraging the extension of this approach, if appropriate, across all local authorities."

2.11 We strongly believe that collaborative working and shared services are the quickest, simplest and most cost effective means of furthering efficiencies in the LGPS.

2.12 Potentially one of the key measures to evaluate performance could be the absolute return achieved by the Fund and the funding level. If a relative performance benchmark is required the best one that we have identified is performance relative to the assumptions made by the actuary in setting contribution rates. Out performance against this measure means that any deficit is being eroded quicker than planned, thus it is meaningful in the fund specific context. However, on different actuarial assumptions this does not allow for meaningful comparison between Schemes and therefore some form of standardisation of actuarial assumptions, at least for comparative purposes, is considered desirable.

3.0 Question 2 – Are the high level objectives listed above those we should be focussing on and why? If not, what should be the focus of reform and why? How should success against these objectives be measured?

3.1 We would suggest that the focus of these objectives should be framed in terms of:

- Ensuring that funds are available to meet pension promises when due (i.e. the management of fund cash flows), and
- Achieving a fully funded and sustainable scheme within the timescale set by the actuaries (i.e. the elimination of the deficit).

3.2 The delivery of increased investment returns is simply one tool to achieve these objectives and in some cases may not be the appropriate tool to use if it fundamentally changes the investment risk balance in a way that is inappropriate to the overall liability profile. Reform needs to make the achievement of these objectives more likely in the medium term than the maintenance of the status quo.

3.3 The way in which we have framed the two objectives enables simple and easily understandable measurement.

- In terms of fund cash flows this is the net flow of cash (i.e. excluding unrealised gains and losses on investments) into the fund from all sources. Further sophistication could be added by splitting the measure between dealings with members and investment income.
- In terms of funding level each triennial valuation will create a "glide path" that shows the funding level improving over time. The simple measure is for actual funding to be measured against this glide path.
- To reinforce the funding level investment performance should also be measured against the actuarial assumption because, that in many cases it is the movement in liabilities rather than poor investment performance that has caused deficits to not reduce in line with the glide path. There is some merit in

looking at investment performance as an independent secondary measure associated with the funding level.

3.4 Using two primary measures and one secondary measure in this way provides a relatively easily understandable way of gauging success by looking at outcomes rather than at inputs.

4.0 Question 3 – What options for reform would best meet the high level objectives and why?

4.1 Cumbria LGPS's would prefer to create a climate where greater collaboration between funds is encouraged, as this creates the opportunity to achieve the secondary objectives outlined within the call for evidence without diluting the current level of local accountability to scheme employers and beneficiaries.

4.2 As stated above we do not accept the argument that larger funds are necessarily better than smaller funds. What is important is whether the strategy is right and its implementation is managed properly and that those overseeing the Fund have access to the appropriate levels of advice, knowledge and skill to be able to deliver a strategy that is right for a fund of any particular size.

4.3 In order to deliver the sorts of strategy that will help LGPS deliver improved funding levels and address the issue of liabilities there is a need to build on the various concentrations of intellectual capital which exist across LGPS but which are not necessarily available to all funds. There are means of doing this which do not need to involve the structural upheaval which the merging of funds would necessitate. These might include for example the creation of investment management teams shared between funds, and thus provide all funds with access to a level of in house resource.

4.4 The recent research undertaken specially to support this call for evidence by Hymans has shown that, while fund size alone is no indicator of performance or even the ability to derive the most competitive fees, what is clear is that in-house investment expertise is generally cheaper than using externally managed funds. These teams tend to only be available to the larger Funds and therefore any means of expanding and then sharing this resource will bring benefits to the whole of the LGPS.

4.5 There is, perhaps, the opportunity for some smaller funds to achieve the same or better returns with lower fees by the creation of some form of pooled investment vehicle, e.g. five or six small funds pooling their active equity mandates as one mandate in order to achieve a critical mass for investment. Equally there are things larger funds could do, in the form of market led solutions, which could offer assistance to smaller funds and some benefit to the larger fund.

4.6 If there were to be established a case that there should be a minimum size for funds either in terms of membership or assets, given that funds outside London cover County areas (whether Shire or Metropolitan) these would seem unlikely to fall below any logical minimum based on the current range of sizes of funds. London is, we would suggest, a different issue, and one which London funds should address amongst themselves. However, given the poor performance data regarding the LPFA we would further suggest that how this be achieved needs very careful consideration.

4.7 Thus Cumbria LGPS believes the best method of maintaining some form of direct local accountability while improving efficiency across the LGPS requires some form of enhanced collaboration resulting in the greater professionalization of the operation of the scheme.

5.0 Question 4 – To what extent would the options you have proposed under question 3 meet any or all of the secondary objectives? Are there any other secondary objectives that should be included and why?

5.1 In general terms the secondary objectives, while logical in their own right, do not flow as might have been expected from the primary objectives. With one exception they represent sensible objectives which it is difficult not to support. To take each of them in turn:

Reduced Investment Fees

5.2 Collective investment vehicles and the development of concentrations of in-house expertise to both run money directly and negotiate with external managers give the opportunity to reduce fees. The Hyman's research shows however that the scale of reductions achievable will be limited. Mandate sizes of £100m, prevalent in most Schemes above £1.5bn, already achieve the lowest fee rates so the scope for further savings is not anywhere near that previously reported in both the press and by some larger schemes in the LGPS.

To improve the flexibility of investment strategies

5.3 The greatest opportunity here is not related to structural reform of the LGPS but the application of the EU Public Procurement rules to the appointment of managers for segregated accounts. This significantly hampers the flexibility and speed with which funds can act if they need to. A situation which makes available greater levels of in-house resource, particularly with skill and expertise in the techniques which allow liability risks to be managed, will certainly increase flexibility. However, funds will need to be prepared to make the upfront investment in either their own or shared in-house teams in order to maximise the potential benefits.

To provide greater investment in infrastructure

5.4 This is not an appropriate objective for inclusion here. Pension Funds exist to secure the resources necessary to meet the pension promises made to beneficiaries. Funds will invest in infrastructure if appropriate opportunities with the correct risk and return characteristics are presented to them. Hyman's research has also highlighted that there exists a potential opportunity to reduce fees across the more expensive alternative asset classes such as infrastructure by enhanced use of internal resources. As such a greater level of in-house expertise, which we believe is best achieved through collaboration, will potentially provide the opportunity to investigate and fully examine proposals more effectively as they come forward.

To improve the cost effectiveness of administration

5.5 The Cumbria and Lancashire funds provide a strong case study in the financial and other benefits that can be achieved through collaboration in the area of administration. Through a shared service agreement the administration team in Lancashire took on work previously delivered by a private sector contractor which has reduced costs and improved the quality of service delivered to scheme members and the fund as a whole. In addition this has delivered considerable savings for Cumbria as well as upfront investment in new technology which provides the bedrock for improved customer service for Lancashire. Procurement and implementation was completed in a total timescale of 10 months which demonstrates what can be achieved by willing partners without the distraction and additional costs of structural changes to Funds.

To provide access to higher quality staffing resources

5.6 Hymans research showed that there is the potential to reduce costs through the development of dedicated in house investment expertise, especially for some of the more expensive alternative asset classes To provide more in-house investment resource, certainly the ability to create stronger in house teams, across the LGPS, should deliver this, but we would argue that this does not in itself require the creation of larger funds.

5.7 It is a matter for administering authorities to decide how they want to run their funds, and investing in appropriate training and expertise of both Committee Members and staff is already a core governance requirement. Cumbria County Council as Administering Authority for the Cumbria LGPS, (considered to be a midsized Fund), has already taken the initiative to strengthen the finance team servicing the Cumbria Fund, and also to take advantage of sharing expertise from other Funds. Even in some of the larger Funds there is a danger in creating small pockets of expertise and sharing a resource such as we and some other funds have done is a simple, and relatively low cost, method of delivering these benefits quickly and efficiently across the whole of LGPS.

5.8 Ensuring the proper administration of any LGPS Fund requires appropriate resourcing. Even a mid-sized LPGS fund involves the responsibility of managing millions (to billions) of pounds, with most Schemes being many times larger in financial terms than the budgets of their administering authorities. Professional advice (e.g. financial, investment, governance or legal) should be appropriately resourced and staff need to be trained and competent, and this is a requirement irrelevant to fund structure or size.

6.0 Question 5 – What data is required to better understand the position of the Local Government Pension Scheme, the individual Scheme fund authorities and the options proposed under this call for evidence? How could such data be best produced, collated and analysed?

6.1 As indicated in question 1, within the LGPS, there is a great deal of information publicly available, however, there is discretion in preparing the information and this makes comparisons challenging.

6.2 For there to be confidence in the conclusions drawn from any analysis of the data, it is imperative that the basis of the preparation of that data is more prescriptive than at present, and audited to avoid ambiguities. This applies not least to the valuation bases used.

6.3 CIPFA already collates information from a number of funds who participate voluntarily in the benchmarking of administration costs. It would seem sensible if CIPFA was used to set out a clear basis for the preparation and submission of administration and investment costs, collate and analyse the data.

6.4 In relation to pension's administration, granular information on the costs of the various functions within a pension fund would help to identify areas of efficiency and good practice.

6.5 Focusing purely on costs risks overlooking some aspects of quality that are less obvious but valuable. The following are examples of activities that will increase administration costs but will have cost and efficiency benefits that will not show up immediately:

- a data cleansing exercise will improve actuarial calculations and reduce the likelihood of incorrect pension payments
- an analysis of longevity of scheme members may reduce contribution rates
- the active management of employers' with weak covenants in relation to bonds, guarantees and other risk reducing activities.

Administration costs

6.6 A number of voluntary initiatives have been ongoing for several years; one of the most widely used being the CIPFA benchmarking study of administration costs. However, as the numbers are not audited, participants lack confidence in their robustness.

6.7 Although SF3 returns to DCLG are audited and form part of pension funds' annual accounts, there are some inconsistencies in the data nonetheless due to:

- internal/external management of funds,
- different auditing regimes,
- the allocation of costs between investments, administration and the fund, and
- greater visibility of Metropolitan funds relative to the more integrated non-Metropolitan funds, to the allocation of central charges by administering authorities.

Investment costs

6.8 It's necessary that investment costs are analysed firstly as a percentage of assets under management (AUM) and secondly that performance is analysed on a relative rather than an absolute basis. The cost per member basis derived from the SF3 return is meaningless.

6.9 We outlined our suggested measures of success in answer to question 2 there is a great deal of benefit in collecting other cost and volume data for funds in order to promote the process of continuous improvement across LGPS. However, as we have emphasised throughout our response, to be of real use these data must be comparable.

6.10 At the heart of achieving comparable data are clear and easily understood definitions of the data items to be reported. This should avoid funds having to apply judgements to source data in order to allocate items to the correct headings. Anecdotal evidence would indicate that there are differences of understanding of the current definitions across LGPS funds. There are a range of concerns expressed around the way in which charges between host councils and funds are calculated, which leads us to support the call for more prescription in this area.

6.11 There are significant issues with the reporting of investment management fees. Depending upon the way in which investments are made, the fees may be transparent or, as in fund of funds type investments, somewhat more opaque. It would perhaps be helpful for such fees, including in-house investment costs to be compared using the standard measure of bps relative to assets under management. However, it needs to be accepted that different investment strategies will lead to different fee levels and the data should not be used to reinforce a drive towards a common low cost investment strategy. The costs of delivering a strategy must be seen in the context of whether or not it has delivered its objectives. Almost all funds participate in the WM local authority universe which measures investment performance although there are felt to be some limitations with this and simply looking at a local authority universe and the understandable focus on the performance of funds within the local authority league table means that these data are not as useful as they might be.

6.12 Given that the data collection machinery for the SF3 return already exists within CLG it would seem sensible to maintain this as the means of data gathering, but with the enhanced prescription as detailed above. There might however be merit in transferring these responsibilities and the associated resources to the new Scheme Advisory Board. This will give greater ownership of the product by Funds and provide a forum which can encourage discussion of the results across the scheme which is not the case at present.

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