Croydon Council

REPORT TO:	**PENSION COMMITTEE** **8 July 2014**
AGENDA ITEM:	**9**
SUBJECT:	**Consultation on the Future Shape of the Local** **Government Pension Scheme**
LEAD OFFICER:	**Director of Finance and Assets (Section 151 Officer)**
CABINET MEMBER	**Councillor Simon Hall** **Cabinet Member for Finance and Treasury**
WARDS:	**All**
CORPORATE PRIORITY/POLICY CONTEXT: Sound Financial Management: The Government is consulting on the future of the Local Government Pension Scheme. This Committee has responsibility for providing guidance on the management of the Scheme.	
FINANCIAL SUMMARY: There are no financial considerations directly arising from this report although the implications for the future cost and financial viability of the Scheme are profound.	
FORWARD PLAN KEY DECISION REFERENCE NO.: N/A	

1. RECOMMENDATIONS

1.1 The Committee is asked to note this report and to provide any guidance to officers on the form of the response to the consultation that they deem appropriate.

2. EXECUTIVE SUMMARY

2.1 This report provides the context to the Department for Communities and Local Government's most recent consultation on the Local Government Pension Scheme. The report discusses collective investment vehicles and passive management of assets. The assumptions underlying this consultation are discussed and challenged. The report recommends the approach for responding to each of the five questions posed by the consultation.

3. DETAIL

3.1 The Government are consulting on opportunities for collaboration, cost savings and efficiencies within the Local Government Pension Scheme. This consultation sits within the context of recent initiatives from the Government aimed at addressing the long-term sustainability, equality and affordability of the Scheme, including reforms to the Scheme itself, such as the new LGPS operating from 2014 and the introduction of auto-enrolment. The Government's concerns focus on the impact on the tax-payer as ultimate funder of the Scheme. There has been a debate around the question of merging funds into a super-fund or a series of regional funds. The Secretary of State has decided these proposals are not viable and that local accountability should be maintained.

3.2 This consultation follows on from Lord Hutton's Independent Public Service Pensions Commission's report, published March 2011, and a call for evidence last summer. In response to this debate and as part of the on-going pursuit of best value local authorities have engaged with the fund management and advisory industry, driving down costs and looking for better ways of working. Fund management fees have been aggressively driven downwards. This authority was the first in the country to launch Frameworks for the delivery of key services, shortly followed by the West Country framework. 15 authorities have signed up to the Croydon Actuarial Services and Benefits Consulting Framework. Croydon are one of the founding partners of the National LGPS Framework, which includes approximately one third of all LGPS and covers actuarial services, investment advisors, custodial services and legal services. This authority hosts a standing London-wide officers' forum and a collaborative working group. Other authorities across the country are combining or sharing services to drive down costs. This Council will be a shareholder in the first collective investment vehicle.

3.3 It is clear therefore that there is a great deal of activity in this area, largely generated by local authorities themselves, concerned to address the issue of the affordability of the scheme but also to leverage the benefits of collaborative working.

3.4 This current consultation is informed by responses from local authorities to last year's call for evidence, from submissions from the shadow national Advisory Board and by a report commissioned from Hymans Robertson. This latter makes some ambitious claims about the scale of savings available.

3.5 The figure of potential savings quoted is £660 million per year across the LGPS.

3.6 The proposals contained within this consultation are as follows:

- **Proposal 1**: Common Investment Vehicles;
- **Proposal 2**: Passive fund management of listed assets;

- The Government are also concerned about improving the transparency of fund data;
- There is an invitation to submit feasible proposals for the reduction of fund deficits; and
- A suggestion of future reform of administration once the current administration arrangements have matured.

Proposal 1: Common Investment Vehicles

3.7 There is a legal distinction between a Common and a Collective Investment Vehicle: the London project is working towards establishing the latter in the form of an Authorised Contractual Scheme (ACS). ACS are a recent additional to the suite of legal vehicles available to institutional investors and intended to compete against similar entities domiciled in Ireland or Luxembourg. The ACS will be UK mainland domiciled.

3.8 The Consultation asks for responses to 4 questions relating to collective investments. These relate to whether the authority is supportive of the concept; local governance and accountability; how many of these there should be; and the type of vehicle. Given that the authority has committed to being a shareholder in the London CIV, in the form of an ACS, the response to these questions will reflect the work that has already gone into that project and will be supportive of this proposal.

Proposal 2: Passive fund management of listed assets

3.9 The question about the merits and demerits of active and passive management is more vexed. Although this authority has a current strategy that is tilted towards passive management of equity this is a response to the current market environment. This environment will certainly change and the appropriate investment strategy will be reviewed in response to that change. The Government proposal is to move all investment returns nearer the average for the entire LGPS. This will obviously help those under-performing funds but at the cost of better performing strategies. This authority’s response would be to encourage better governance so that investment decisions are better informed. There is a risk that must be avoided that future investment returns are sacrificed for the sake of comparatively small fee savings.

Transparency of fund data

3.10 The current financial reporting requirements for Pension Funds and benchmarking of investment performance do not provide comparability, transparency and look through to fund managers’ costs. However this is a technically complex area and although this authority would encourage greater transparency this cannot be achieved by a simple reform of the LGPS. This is an industry wide issue, involving international fund managers, banks and exchanges. Given recent scandals relating to the setting of bank rates such as LIBOR, foreign exchange rates and so forth it is probably beyond the ability of any single government to influence independently.

3.11 Steps could be taken to improve the comparability of performance between funds so that pooled and segregated funds, for instance, could be meaningfully compared. The underlying costs are far more difficult to unpick and will continue to obscure true performance.

Fund deficits

3.12 The future shortfall between the assets of the LGPS and forecast liabilities is often referred to as the funding gap. This is a notional liability but all scheme employers are required to make an annual lump sum contribution towards it. The existence of a funding gap is a recent phenomenon and factors contributing to its existence include the global financial crisis, historic contribution holidays and the imposition of taxation on equity dividends.

3.13 Possible responses to this issue have included setting a lower funding level, for instance 75% of liabilities, instead of 100%; changes to the assumptions used by actuaries in calculating liabilities; or making significant voluntary contributions such as massive cash injections into the Pension Fund.

Future reform of administration

3.14 The administration of the Scheme has undergone significant changes following the introduction of the 2008 scheme, the 2014 scheme, local government responsibility for the NHS scheme for local authority employees, auto-enrolment and major out-sourcing arrangements. None of these changes have been fully and objectively assessed. The last reform was lauded as being a reform for a generation. Before any further disruption is envisaged it is important to understand how costs have changed and what performance measures are appropriate for the Scheme. Once a benchmark has been agreed and established a period of data collection and reflection is required before any assessment of affordability, value for money or sustainability can be made.

3.15 For the sake of completeness the five questions posed by the consultation are as follows:

Q1. Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Please explain and evidence your view.

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

Q3. How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?

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

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

Savings

3.16 The consultation makes some sweeping assessments about the level of savings that can be achieved through the proposals put forwards. CLG suggest that, across the LGPS £420 million can be saved by moving from active to passive management of listed assets. £230 million of this sum would be from a reduction in fees and the balance from a reduction in transaction costs. An additional £240 million relates to top-tier fund of fund fees avoided. Further the CLG believes that these figures are understated without offering evidence to substantiate that claim.

3.17 Broadly speaking, the Croydon fund pays about £1 million in fees to manage its equity investments each year. Converting that entire portfolio to passive management would save c. £600,000 p.a. *ceteris paribus*. Applying the CLG savings figure proportionately to the Croydon fund would result in fee savings of c. £50 million. Clearly there is a deficiency in understanding how the CLG have derived their figures for this consultation.

3.18 Although there is little dispute that the greatest savings are to be had by challenging fund manager fees two significant factors need to be considered. The first is the success that authorities have already enjoyed in negotiating with fund managers. The second is that performance reflecting in the growth in the value of assets far exceeds these potential savings. Finally, with reference to the point discussed above, there is insufficient transparency at present to allow a full understanding of underlying transaction fees let alone enough to accurately forecast a figure for potential savings.

3.19 A final point relates to the CLG's view that these savings would accrue to tax-payers. Certainly a better performing fund will result in better triennial valuations and hence more modest contributions from Scheme employers, the majority of whom are tax-payer funded. But there is no mechanism currently to allow for a reduction in employer contributions. There is a requirement for actuaries to smooth contribution rates and therefore it is unlikely that initial savings will reflect in lower contribution rates. What is more likely is that savings will result in shorter recovery periods so that over a period of time, say 20 to 25 years there will be savings..

3.20 In conclusion therefore, this report is broadly supportive of the creation of at least one collective investment vehicle to improve the efficiency of selecting best in class fund managers and saving on management fees. The choice of investment strategy must always be the prerogative of local authorities as circumstances, risk appetite and demographic factors vary. A focus on better governance and allocation of sufficient resources will result in better investment decisions. The appropriate response to this consultation will be to encourage those current ad hoc and local arrangements and to prompt central government to actively support these initiatives through funding and a central co-ordinating and information exchange function.

4. RECOMMENDATIONS

4.1 The Committee is asked to note the contents of this report and provide such input into the response to the consultation that they feel appropriate.

5 FINANCIAL CONSIDERATIONS

5.1 There are no further financial considerations flowing from this report although the longer term savings that may accrue from these proposals are significant although currently unquantifiable.

6. OTHER CONSIDERATIONS

6.1 Other than the considerations referred to above, there are no customer Focus, Equalities, Environment and Design, Crime and Disorder or Human Rights considerations arising from this report

7. COMMENTS OF THE SOLICITOR TO THE COUNCIL

. 7.1 The Council Solicitor comments that there are no specific legal comments arising from this report

(**Approved by:** Gabriel MacGregor, Head of Corporate Law on behalf of the Council solicitor and Monitoring Officer)

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Appendix

Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies. A Consultation. May 2014