Bath & North East Somerset Council

Avon Pension Fund

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Dear Ms Edwards

Call for evidence on the future of the Local Government Pension Scheme (LGPS)

Thank you for the opportunity to respond to the call of evidence on the future structure of the LGPS. The paper seems to make the assumption that the investment costs, investment performance and size of LGPS funds are correlated and therefore the funds are inefficiently managed. We do not believe there is evidence to support this assumption. The key problem all funds face is managing the liabilities which are determined by central government regulations not local policy. Therefore we believe that the focus of reform should be on enabling LGPS funds to work better together by reducing the restrictions around investment and procurement regulations and through the simplification of the LGPS regulations in general.

The Avon Pension Fund's response to the five questions is as follows:

Question 1 - How can the LGPS 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?

The current structure of the LGPS Funds already has a high level of accountability to taxpayers and other parties for the following reasons:

(i) They are highly regulated and legislation requires detailed disclosures about local funds e.g. financial accounts, investment and administration performance and costs, and statutory policy statements.

(ii) Best practice governance arrangements ensure stakeholders are represented in the decision making process

Furthermore, the shadow National Scheme Advisory Board (the "Board") is now in place to ensure best practice is enshrined throughout the LGPS in respect of governance and transparency of data. Having established such a body, with wide representation, it would seem illogical to not allow it to fulfil its role.

The Avon Pension Fund ("the Fund") has a Committee and an Investment Panel, representing a wide range of stakeholders, which provides strong local accountability to members, employers and taxpayers. This is particularly important given the continuing fragmentation of the employer and membership base away from the local authorities. The Avon Pension Fund also has the benefit of independent challenge from two independent voting members, which helps to reinforce local accountability on a consistent basis irrespective of the political environment. A locally based governance structure also fits in with the government's Localism Agenda. As a locally based fund, it is able to hold a wide range of employer and member forums and events each year ensuring all stakeholders are fully informed and engaged with issues affecting the Fund and LGPS. These meeting are complemented by our website and communications activity.

The Fund adheres to a high level of disclosure with a significant amount of information made publicly available on our website, including meeting agendas, minutes, annual reports and statutory documents. The Fund discloses all administration and investment costs in its annual report. Administration and investment performance is disclosed quarterly in the committee and panel papers (see later answers for comments on comparing costs and performance)..

Whilst it may be possible to achieve economies of scale given the variation in the size of funds across the LGPS, cost efficiency cannot be the only objective to drive the governance structure. Local accountability and provision of a quality service to members and employers are also key objectives. Therefore determining the optimum size of any fund must take these into account.

Therefore it is not clear how changing the structure of the scheme will improve accountability and efficiency compared to the current structure which allows local funds to make local decisions to meet their own local circumstances.

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

We would support the high level principles but believe they ignore the purpose of the LGPS - to provide a good quality pension service which should be another high level objective. Another high level objective should be enabling funds to work together more easily. If funds work collaboratively without incurring reorganisation costs, efficiency should increase and costs be managed more effectively.

Although dealing with deficits is a key issue affecting all funds it is difficult to understand how structural reform of the funds will resolve this issue as the scheme structure and more to the point the employee benefit structure is determined by legislation. The only way to meaningfully address the deficits, given the size of the liabilities, is to reform the benefits structure, in particular the accrued benefits which has not been addressed in the LGPS 2014 scheme.

Sustainable pensions require deficits to be managed, and the size of deficits far outweigh the costs of investments and administration, especially after the costs of transitioning to a newly reformed structure are taken into account. LGPS funds as currently structured have scope to mitigate liability risks through their investment and funding strategies.

Investment performance is key to minimising deficits given that it is the funds only controllable variable. A small deviation from performance targets will have a significant impact on the funding position compared to changes in the investment and administrative costs. As at 31 March 2013 the Avon Pension Fund is valued at £3.1 billion with total costs (administration and investment) of £13 million or 0.42% of the Fund's assets (of which 0.33% relate to the costs incurred in the management of the Fund assets). A 0.5% underperformance of investment returns would therefore cost the Fund c. £15 million i.e. more than the total costs. Given the 10 year investment return achieved by the Avon Pension Fund is 9.6% p.a., the total cost base of 0.42% is paid for by c. 4% of the money generated by investment returns annually.

Therefore the investment strategy and not investment costs are the driver of performance. The Fund regularly reviews it strategy, has built diversity and flexibility into the strategy to enable it to take advantage of market opportunities and ensures there is an appropriate balance between risk and return. The adoption of more diversified and risk focused strategies has increased the investment management fees. However, such strategies are expected to generate superior risk adjusted returns net of fees to assist in managing liabilities, especially in the short term.

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

The options for reform being debated range from keeping the status quo, to increased collaboration, to regional/national mergers.

Status quo retains locally accountability with funds able to make decisions in respect of service delivery and investment strategy that it determines is in the best interest of the fund.

Currently there are a number of initiatives that demonstrate how LGPS funds can be structured, for example, LGSS in Northamptonshire and Cambridgeshire, Devon and Somerset's shared administration service, the South West (SW) framework agreements for specialist advice (in which the Fund participates) and the national framework agreements. These arrangements address efficiency and quality of service delivery, reducing procurement costs and increasing value for money, all of which are achievable through collaboration rather than merging of funds. The SW framework agreements have produced cumulative savings of £1.5m to date and will continue to generate savings into the future by minimising procurement costs and achieving competitive fees. The Fund will use the SW framework agreements when it re-tenders its actuarial and investment advisory contracts in 2014.

Many funds already work collaboratively at a local or regional level. For example, the SW funds are producing regional communication materials for the LGPS 2014 scheme, using generic materials from the LGE.

There are also initial signs of collaborative work within investments, for example, the collaboration by the five funds (Greater Manchester, West Yorkshire, South Yorkshire, West Midlands and Merseyside) to set up a £250m investment fund to invest in projects to promote economic growth. Such collective investment schemes could become an effective way for LGPS funds to work together to improve investment returns net of costs, but with each fund investing in line with its own investment strategy.

A recent analysis of LGPS funds by WM Performance Services shows a lack of correlation between the size of funds and investment performance.

Without overwhelming evidence to demonstrate that larger funds achieve superior investment performance it is difficult to argue for the creation of larger funds. The costs of transitioning towards a new structure, that would have to address the issue of local accountability, is likely to outweigh any savings through better economies for scale, especially in the short to medium term. In the short term it could potentially generate increased costs.

There are also a range of as yet unquantifiable risks associated with creating larger funds; the potential reduction in competition within the investment industry, the capacity to manage larger mandates which could deter specialist, boutique managers from bidding for mandates, greater concentration risk and potentially greater volatility of returns as strategy diversification is reduced.

To facilitate greater collaboration between funds, the regulations need to be clarified and simplified. The restrictions in the investment regulations need to be removed to enable collaboration on investment strategies and the procurement rules altered to reduce the bureaucratic process for establishing framework agreements and other innovative ways of working together.

In summary, collaborative working is enabling the LGPS to meet the high level objectives and therefore reforms should focus on enhancing these opportunities. There is already significant momentum around such initiatives and any gains could be lost if funds have to focus on transitioning to larger funds. In addition, uncertainty over the structure of funds could reduce the focus on investment strategy and could possibly lead to funds delaying or postponing investment decisions to avoid incurring advisory and transitional costs.

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?

Our answer to Question 3 covers some of the secondary objectives, mainly cost effectiveness of administration and investment strategies.

Additional points are:

(i) To improve greater flexibility of investment strategies and reduce investment fees, a complete revision of the Investment Regulations is required. This would enable funds to invest as they think appropriate and reduce money spent on obtaining “advice” as to whether an investment is permitted under the regulations. In addition, investing via collective investment vehicles will assist funds, especially the smaller funds, accessing the full range of investment opportunities at a lower cost.

A recent benchmarking survey (sponsored by Hymans Roberson) on LGPS investment management costs concluded that LGPS costs are comparable to a peer group of pension funds. The research shows that investment manager fees paid by LGPS funds are competitive and suggests that merging of funds will not significantly lower fees. It does note that lowering of fees on the more expensive alternative asset classes could be achieved through investing via collective investment vehicles.

(ii) Given the changes already made to the regulations to facilitate investment in partnerships, funds are able to invest in infrastructure, if it meets their investment objective. There are appropriate collective vehicles available for indirect investing and the proposed Public Infrastructure Platform should channel funds into UK public sector infrastructure as well as private sector projects. Therefore this should not be an objective of the reform.

(iii) Access to high quality staffing resource (assuming this to mean more experienced, better qualified and more skilled) will vary across the country. It should be recognised that there is a highly competitive market place for such staff, especially in investments, where local authority pay scales are not competitive with the private sector and creating larger funds will not necessarily address this issue. Collaboration between funds on expertise, for example informal “centres of excellence” for more complex strategies such as liability hedging, could provide better resources and expertise. The viability or not of this could be considered by the National Scheme Advisory Board in due course.

(iv) Again collaboration could be a way of utilising and scaling up in-house investment expertise without full merger or shared service.

(v) In respect to cost effective administration, another area where LGPS funds are incurring additional costs and having to manage significant risk is in the increasing fragmentation of the employer base. Avon Pension Fund has almost 200 employers and it continues to grow, mainly due to the creation of Academies and continued outsourcing by scheme employers. The experience of these new arrangements is that pension matters are not a priority for these new organisations who often find themselves in difficulties falling foul of regulations. Administration authorities have to work hard with employers to resolve these issues and ensure they understand their responsibilities. Therefore, it would help if the LGPS Regulations were strengthened in this area making clear the legal responsibilities of scheme employers and giving funds greater and more immediate powers to take punitive measures. This would give a better balance between enabling and encouraging free market competition and innovation in public service delivery with its impact on the LGPS funds.

Question 5 - What data is required in order to better assess the current position of the LGPS, the individual scheme fund authorities and the options proposed under this call for evidence? How could such data be best produced, collated and analysed?

Whilst the LGPS generates a significant amount of data at the local level (especially in annual reports), analysis at the national level is limited to the WM Investment performance statistics, SF3 returns and the CIPFA Benchmarking club for administration costs (all of which the Fund participates in).

The provision of comparative data is very useful to funds in setting budgets, comparing performance and for disseminating cost and performance information to a wider audience. Therefore, development of the existing comparative data should be considered as part of the remit of the National Scheme Advisory Board. The analysis of any data must be meaningful, give consistent insight that can be used by funds in managing budgets and informing decisions and must be over relevant timescales.

In the case of investments, investment strategies are set over the longer term therefore, analysis over multi-year periods is appropriate. In addition, the analysis must include the level of risk associated with the overall strategy as well as returns. Investment costs are not currently benchmarked and as investment fees are usually referenced to assets under management, monetary costs identified in annual reports are not meaningful comparisons. Therefore costs should be benchmarked as a per cent of asset values or cost per member. Any analysis must be on a comparable basis with clear instructions on the costs to be included (for example, under current accounting conventions not all funds include pooled fund fees that are deducted at the pooled fund level in their annual report, thus understating fees). However, the fee rate charged for an investment mandate will vary according to the size of the mandate and the complexity or resources required for the mandate (for example, a UK equity mandate with a Socially Responsible Investing (SRI) approach may attract a higher fee than the same mandate without the SRI input). The disclosure and analysis of investment data and costs needs to be improved to give a meaningful comparison of efficiency and value for money across the funds. Ultimately what matters is the net investment return after taking into account fees paid.

Pension administration is more suited to benchmarking costs given the homogeneity of the processes. However, the current benchmarking focuses on costs and does not effectively incorporate value for money or quality of service. The data is not always consistently disclosed which can lead to misleading analysis. The Avon Pension Fund sets its own budget and clearly identifies the services it “buys” in from the council. Furthermore, the Fund has made significant decisions over recent years to invest in capacity, mainly IT systems and to a lesser extent staff, to ensure it increases productivity yet maintains a high quality service whilst implementing the new scheme. Such “investment” can increase short term costs significantly before generating lower costs per unit in the medium term. A facility for the cost of investing in software/hardware to be spread over the useful life of these assets should be incorporated into the benchmarking exercise. The output of the benchmarking analysis is detailed but it is not easy to identify whether funds are cost effective and providing value for money.

With a national body established, it would be sensible for the National Scheme Advisory Board to collect, analyse and publish data for the scheme as a whole and comparative fund data. This would assist local funds to benchmark their own performance and costs to inform decision-making. It would also increase transparency and accountability to the taxpayer, members and employers and demonstrate value for money. The Scheme Advisory Board should decide on the information to be collected and frequency of the analysis. As much of the information is already available, refining the analysis should not entail significant additional work or costs.

Conclusions

The Avon Pension Fund believes that current initiatives around collaboration and shared services determined by local funds are the most effective and appropriate way that the LGPS will improve efficiency and investment performance. The workload facing these funds is ever more demanding given the fragmentation of the employer base and introduction of the new scheme. Challenging funding positions require greater interaction with employers by funds and greater scrutiny of investment strategies and opportunities. All of this supports maintaining locally managed funds, collaboration and use of collective investment vehicles in areas that generate greatest value for money. The Avon Pension Fund’s policy is to participate in collaborative initiatives, either within the south west region or nationally and the Fund is exploring shared arrangements with other local funds.

Yours sincerely,

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