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NATIONAL CHANGES TO LOCAL GOVERNMENT PENSION FUNDS

BRIEFING NOTE/GENERIC REPORT

Introduction

1. During 2013, Government consulted on some fundamental changes to the 89 Local Government pension schemes funds in England and Wales. Further consultation is expected shortly following research Government commissioned on three potential collaborative models for consideration:

   - A common investment vehicle at England and Wales level, with asset allocation strategies still determined by the local pension funds;
   - 5-10 common investment vehicles across England and Wales, for example based on aggregate fund size or geographical areas, again with asset allocation strategies decided by local governance structures;
   - A much more centralised approach with 5-10 merged funds across England and Wales. These may be based on fund size or regional areas (as above). Decision-making would be taken by new governance arrangements at the merged fund level.

Our Views

2. We welcome a debate on how to improve efficiency in the LGPS. During the current economic climate more than ever each Fund must show good value to local taxpayers.

3. Investment Manager fee levels have received attention in the press as a concern. But the notion that low fees for Investment Managers is good and high ones bad is simplistic. Ensuring fees are strongly linked to Fund performance, so that taxpayers benefit if fees rise as more pension liabilities will be met from good investment returns rather than their taxes, is more important than measuring absolute management cost.

4. Reasons against a full blown merger of funds approach are:

   - ***Costs*** - one of the primary considerations when considering a merger of Funds is the costs involved. The prospect of merger to ‘regional’ funds is both complex and the transition would be costly with a long lead-in time. Even if there are longer term benefits (which is far from generally acknowledged), in the current climate the short term costs may not be practical.

   - ***Undermining the local Funding Strategy*** – We have a strategy for our approach to investment that reflects the appetite for risk. We can also take a long term view, due to our good funding position and the covenant of employers within the Fund, and this flows through to our investment strategy and the contribution rates set. Not all funds have this benefit – needing the cash sooner to pay for pensions and needing to take higher risks. Merging funds regionally and having less autonomy means you may end up with the ‘wrong’ asset allocation for the profile amount and liabilities you face locally.

   - ***Loss of Autonomy*** - Local democratic oversight would be much less in evidence via a small number of extremely large funds and if there is a strongly performing local fund what is being added?

- ***Increased Risk*** – currently one of the advantages of having numerous individual funds with their own decision making is that risk is diversified across all Funds. Should funds be merged, producing for example six or seven large regional Funds of £10bn+ assets, should any single Fund falter the funding level for a large proportion of the LGPS liabilities would suffer. Put simply, much larger eggs would be in far fewer baskets.

- ***Deficits not improved*** **-** one of the key objectives of the structural reform is around "Dealing with deficits". But a merger would have no impact on funding positions for any employers within merged Funds. In short, if you merge two funds with £500m deficits, you now have one fund with a £1bn fund deficit – probably with a lot of short term distraction away from investment returns- so where did you gain?

South East 7 Initiative

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5. As a response to the Government's proposals, the Pension Fund authorities within the South East 7 have been looking to work together to pool their pension fund asset management. This would allow each authority to maintain control of its strategic asset allocation whilst benefitting from significant economies of scale from a combined fund worth in the region of £11bn-£12bn. This is in its early stages, and would critically depend on the direction of Government policy before any firm commitment to proceed from the authorities concerned can be made. The principle behind this work is that is it better to encourage like-minded authorities, with sound governance and funding arrangements, to preserve these advantages by permitting a self-designed reform rather than have a Government imposed solution.

6. It is envisaged that there is a chance to pool the asset management function across the south east, creating a pathway for collaboration, opportunities for new investment classes and cost reductions. The initiative recognises Government's legitimate right to set aspirations for improvement but is also aligned to localism – tailoring pension funds to the needs of the participant authorities to strengthen their employer covenants. A simple collaboration model could work by allowing individual administering authorities to retain ownership of their assets invested via a pool, exercising their own fiduciary responsibilities and strategic asset allocation whilst reaping benefits from collaboration such as economies of scale and reduced procurement costs.

7. Table 1 below shows how the authorities compare. The fund would cover over 300,000 active, deferred and pensioner members and so would have a strong 'critical mass'.

8. It is too early to say what the national average funding level under the 2013 valuation is, but the crude average among the Funds who use Hymans Robertson as their actuary is around 75% (without adjusting for variations in underlying assumptions). The typical funding level across the country in 2010 was around 75%. It appears therefore that the South East Funds shows up well in comparison (see table 1). It should be noted that the assumptions that underpin funding levels for different counties may vary, for example the discount rate which is also given in the table.

TABLE 1: PENSION FUND DATA

Fund	West Sussex	East Sussex	Surrey	Kent	Hampshire	NationalAverage*
Funding level in 2013	86.4%	81.2%	72.3%	82.8%	80%	75%
Assets	2,370	2,344	2,559	3,786	4,341	n/a
Liabilities	2,741	2,885	3,538	4,570	5,428	n/a
Discount rate	4.6%	4.6%	4.6%	6.0%	5.5%	variable
Actuary	Hymans Robertson	Hymans Robertson	Hymans Robertson	Barnham Waddington	Aon Hewitt	Hymans clients

*Initial estimate based on Hymans Robertson clients

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Conclusion

9. If mergers take place, this will clearly be the focus of considerable governance and officer attention in the short term, detracting the focus from performance. Given our good performance as a Fund, the case for major change needs to be overwhelming proved to proceed – something we don't believe has been demonstrated.

10. Whilst some Funds are clearly performing less well than those across the South East, we would urge against any solution that 'throws the baby out with the bathwater'. A one size fits all solution, such as a large scale merger of funds, risks the dangers outlined above and losing the good skills and performance demonstrated by the high funding levels emerging from the 2013 Valuation across the South East Funds.

11. The five Authorities have sought to work together to map out a viable framework of joint working consistent with Government views to date. This is a process that inevitable can be challenging with different ideas on the vision and the way ahead. For collaboration to work effectively across five Funds, clearly agreement will need to be reached with all to participate in a suitable model, including the right size for a more collective approach. Without sight of Government's (overdue) proposal, this is difficult to anticipate in detail. Once Government has set out its aims, in the consultation paper due out, this work can continue with more urgency.

Recommendations

12. The report is noted

13. If Government indicates it wishes to proceed with full scale reform of the LGPS funds, the Pensions Panel support this initiative and any resource needed to develop a subsequent business case. This is subject to 'no change' not being an option available to maintain the existing Fund management and governance arrangement as the first preference, and the South East 7 proposal as outlined being in keeping with any Government's intention for enhanced collaboration.

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