Local Government Association

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Sent by email to LGPSReform@communities.gsi.gov.uk

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Dear Chris

Call for evidence on the future structure of the Local Government Pension Scheme

I set out below the LGA response to the call for evidence published by the department on 21st June 2013.

The comments in respect of evidence around the performance of larger funds are derived from the attached report '**Do Larger Funds Perform Better?'** produced by State Street Investment Analytics and jointly funded by the LGA with Bradford and Tameside MDCs.

In summary the report points to the following potential advantages of larger LGPS funds:-

(i) Larger funds can access external management at lower costs.
(ii) Historically, internal management has provided superior returns. Larger fund size would give local authorities the opportunity to use internal management to a greater extent than currently.
(iii) Larger funds may provide the potential for improvements in scheme governance.
(iv) Larger fund sizes may provide better opportunities for investment in certain asset classes.
(v) Larger funds will have bigger governance budgets, enabling better decision making.

The view of the LGA is that provided such advantages are both demonstrated by other evidence submitted and can be cost effectively realised in a manner which minimises risk to local authorities then reform which aims to result in fewer, larger funds should be supported.

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With regard to the second element of the above statement the risks which in our view will need effective management are as follows:-

'In extremis' financial risk
Current examples of local or pension fund authorities providing the scheme manager[1] function display a marked difference in the ability of those authorities to provide for 'in extremis' funding of statutory LGPS benefits. Whereas the Statutory Instrument setting up the South Yorkshire Pensions Authority (SYPA) (1987 2110) confers a power to levy:

Reimbursement
4.—(1) The net expenditure of the Authority in any financial year shall be apportioned between the district councils in the county of South Yorkshire in proportion to the population of their districts, as that population is certified for the making of levies with respect to that year under section 74(2)of the 1985 Act (levies by residuary bodies); and the appropriate portions shall be recoverable by the Authority from each of those councils on written demand.

the corresponding SI which transferred the scheme manager function in relation to the West Midlands LGPS fund to Wolverhampton MDC (1991 710) contained no equivalent power. Given that the last resort source of funds for statutory LGPS benefits is the income available to the scheme manager this difference in powers results in a much smaller income base for Wolverhampton (its own council tax base) than for SYPA (the council tax base of South Yorkshire) and therefore a much higher risk of not being able to meet those benefits.

Any reform of LGPS structure should therefore ensure that those authorities which are either created as pension authorities or inherit wider scheme manager functions should be provided with tax raising powers across an area adequate to meeting their statutory liabilities.

Funding risk
Current LGPS funds have a range of funding levels which, although determined to some extent by local assumptions and are therefore not directly comparable, do indicate the success of that authority in meeting its own funding targets.

Any merger of fund assets and liabilities should reflect that level of success in the resulting scheme employer funding levels (and therefore deficit contribution rates) of the merged fund.

Transition risk
There are a number of different ways in which funds could be merged. However, in essence, these fall under one of three methodologies:

Merger of assets (virtual) e.g. Common Investment Vehicles (CIV)

[1] Note that the term 'scheme manager' is used throughout in accordance with the Public Service Pension Act 2013 to denote the body which has been named in regulations as the 'administering authority' i.e. having responsibility to administer the LGPS for the scheme members allocated to it.

Merger of assets (actual) e.g. pooled assets run by a lead authority
Merger of assets and liabilities e.g. full merger into an existing scheme manager or into a new body.

Each of these will have advantages and disadvantages and each will have varying levels of legal, financial and practical hurdles to be overcome for implementation. For example, the CIV option may be the simplest and cheapest to set up as it does not require legislation, transfer of staff or variation of existing contracts. However, for the same reasons its benefits are uncertain and its on-going management and governance is complex. The full merger option on the other hand is the most complex to create (involving as it must secondary legislation) but once done is relatively simple to operate.

The only one of the three methodologies which has been tested in in the last 30 years is the latter and even then only with regard to the setting up of a new body and the transfer of single not multiple funds. The LGA would therefore strongly recommend that more investigation (included the running of real situation pilots) is carried out into the suitability, risks and costs of each methodology before any final decision on reform is made.

Furthermore and notwithstanding the methodology or methodologies selected for reform the LGA would recommend that the temptation to rush such change be resisted. This does not detract from the need to set out a confirmed direction of travel within a reasonable timescale but merely acknowledges that actual implementation should be given sufficient time (including parliamentary time) to be properly carried out.

Future proofing
Although set up as a council centric scheme with one large authority acting as scheme manager for itself or a small number of other councils, the LGPS is undergoing and will continue to undergo significant change.

In particular the number and nature of scheme employers continues to grow (to over 7,000 in 2013 - a growth of 30% in the last two years alone) and now includes bodies such as private sector contractors and academies as well as the traditional third sector admitted bodies. In terms of scheme membership this expansion in employers now means that 25% are not employees of local authorities, a number which will no doubt continue to increase as the efficiency agenda and new fair deal are implemented.

Any grouping of employers into larger funds should therefore consider thematic as well as geographical criteria. For example, why are academies split across so many scheme managers when a smaller number could provide greater consistency of funding and administration?

Existing multi-employer schemes such as those operated by The Pensions Trust operate on a thematic basis presumably for good reasons that the LGPS would be wise to take into consideration.

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Political risk
One of the potential advantages of larger funds set out in the State Street report is the ability to transfer some or all investment management in house. However the report points out that:-

'The IM local authority funds are all managed outwith London which has allowed access to skilled investment management resources at a relatively low cost. It is unlikely that this arrangement would be possible closer to London where the market for such resources is buoyant' -page 12(5)

The report recognises the potential (small p) political risk of in house investment management resources commanding remuneration considerably in excess of that normally associated with the public sector and in particular local authorities. The example quoted of how Canada has managed this risk provides a sensible option for reform.

'In Canada there has been a clear move towards increased level of internal management within their public sector pension funds. Performance of these funds has improved markedly as a result. These funds believe that one of the factors facilitating the improved performance is the ability to attract and retain top investment professionals. This has been done by setting them up as quasi-independent entities that allow the decoupling of salaries of these professionals from existing public sector pay scales. Whilst this has pushed up the cost of internal management, it remains well below that paid by external funds whilst, at the same time seeing an improvement in net performance'- page 12(5)

Administration risk
The LGA are concerned that there may be an assumption that the administration elements of the scheme manager function should automatically follow the reformed structure put in place for assets and liabilities.

The administration of member benefits and the support of scheme employers in delivering their responsibilities is a vital driver to the overall cost of the scheme. The new 2014 scheme in particular places a significant degree of responsibility on employers which if not successfully fulfilled will result in complaints, overpayments, and inaccurate data leading to over cautious and therefore costly valuations.

Therefore as it may well result in a different outcome we would strongly recommend that any reform of administration is carried out as a separate exercise to that for assets and liabilities.

Yours sincerely

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