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Review of the Local Government Pension Scheme Funds in Wales: Costs, Structure and Management

Welsh Government

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Contents

Executive summary	4
Part 1: Scope, issues and initiatives	
Scope	9
Issues affecting efficiency and cost effectiveness	10
LGPS initiatives and actions since 2011	13
Part 2: Review of actions and papers	
Analysis of effect of recent and current LGPS initiatives and papers	15
Quantification of potential performance enhancements supported by papers on the LGPS	16
Part 3: Analysis of different structures	
Introduction	22
Maintaining the status quo	23
Mergers in Wales	23
Establishing a CIV for Wales	24
Using pre-established CIV(s) for England and Wales when available	25
Use of CIV then subsequent potential merger	26
Administration savings	26
Administration and investment: staffing models in Wales	27
Part 4: Local government changes in Wales	
Impact of merger of unitary authorities	28
Appendices	
Appendix 1: Literature review	32
Appendix 2: Estimated investment gains through fund merger or the introduction of a collective investment vehicle	51
Appendix 3: Estimated funding levels by council	54
Appendix 4: Data on current administration and investment costs	61
Appendix 5: A possible collective investment vehicle for Wales	64

Executive summary

Introduction

1. At the request of the Minister for Public Services, the Auditor General has carried out a review of the costs, structure and management of Local Government Pension Scheme Funds (LGPS) in Wales.

Background and context

2. The LGPS is under intense scrutiny to ensure it remains sustainable for the future, whilst at the same time ensuring that it is both efficiently run and cost effective and clearly accountable to all its members and stakeholders.
3. The Department for Communities and Local Government (DCLG) currently has overall responsibility for regulatory oversight of the 89 LGPS funds in England and Wales. The DCLG identified a couple of years ago that improvements in managing the investments of the LGPS were likely to generate efficiencies several times (ie, six to 10 times) greater than improvements in member administration. The DCLG commissioned research on various options, comparing the use of Collective Investment Vehicles (CIVs) and LGPS fund mergers. Hymans Robertson reported on these options in March 2014, concluding that CIVs were likely to be somewhat more effective than LGPS fund mergers in delivering substantial investment cost efficiencies. A high level of CIV take up, whether by mandation or encouragement of voluntary participation, was recognised as essential.
4. The DCLG then initiated a consultation on efficiency indicating that it did not intend to impose mergers on the 89 LGPS schemes in England and Wales. The consultation, entitled ‘opportunities for collaboration, cost savings and efficiencies’ primarily considered the case for CIVs and possible structures for them. However, the consultation gave no steer on whether their use would be voluntary or with some mandation imposed on funds.
5. Consultation closed in July 2014 and the DCLG’s response is expected in June 2015 or later.
6. Under the Public Service Pensions Act 2013, advice on the LGPS is provided to the DCLG by the LGPS Scheme Advisory Board (SAB) from April 2015. Before that, the Shadow Scheme Advisory Board (SSAB) started work on the SAB remit: its Investment and Engagement Sub-Committee has, for example, a work programme on management fees, charges and transactions costs across the 89 funds. Another of its sub-committees, Governance and Standards, decided in February 2015 to consider three options by which the scheme manager function might best be separated from the employer functions of the relevant administering authority. One of these governance options would involve the establishment, by groups of funds, of joint committees under Section 102(5) of the Local Government Act 1972. An option such as this would potentially generate new ways of delivering investment efficiency via increased asset scale.

7. The Westminster Coalition Government (2010-2015) did not seek to dissuade the London boroughs from continuing to make progress on setting up their own CIV with voluntary participation by London LGPS funds. The London CIV is expected to be authorised by the Financial Conduct Authority (FCA) and launched later in 2015. Thirty out of 33 boroughs expect to participate in the London CIV, but it is not clear what proportion of their assets each will commit to the London CIV.
8. Given these developments, we have considered two main options for the eight LGPS funds in Wales. Our review has included the benefits, risks and issues of using CIVs and of merging the Welsh LGPS funds from an investment perspective. The possibilities of more complex governance options (as at paragraph 6 above) have not been considered as part of this report, but we do not exclude them at this stage. We have also considered certain funding, administration, governance and operational issues.
9. Throughout, we have been cognisant of the possibilities for the reorganisation of local government in Wales and of the legal constraints that may be encountered if it were desired to pursue certain options for the LGPS funds. We have sought to identify areas (regarding LGPS management and structure) in which it might be helpful to seek either legal competence for the Welsh Government or a decision from DCLG in line with Welsh Government advice.

Specific structures reviewed

10. There is now a body of research on the LGPS across the UK that demonstrates that increased scale in investment should lead to improved investment performance. Accordingly, we have identified and reviewed the most plausible structures for delivering this scale in Wales. Specifically, we have examined merger of the eight LGPS funds – either to three larger LGPS funds or a single LGPS fund for all of Wales – and the use of a CIV – either to establish a single CIV for Wales or to participate in CIVs that might be established across England and Wales in response to a clear DCLG decision on these. The Society of Welsh Treasurers has already started feasibility work on setting up a CIV in Wales.
11. Wider local government changes in Wales provide an opportunity to also consider the approach taken to local government pensions in Wales. Under the existing arrangements, 22 separate unitary authorities participate in the eight LGPS funds and each has its own funding level determined by notionally tracking its asset share and the liabilities of its members. Current proposals are that the number of unitary authorities would reduce significantly, by merger within four or five years. We have examined possible positions on the hypotheses that there might be nine or 12 unitary authorities. Other revised numbers of unitary authorities are of course also possible: we chose these numbers simply to facilitate credible analysis.

12. We have modelled the impact on the funding positions of hypothetical newly created authorities. These revised funding positions of the new authorities will depend directly on the funding positions of the merging entities which, although within the same LGPS fund in most cases, may or may not be at similar funding levels at the time of merger. In so doing, we have not considered the impacts on LGPS financing from associated reductions in staff levels. These impacts could themselves be significant (either detrimental or positive) but will depend on the age and service profile of staff leaving.

Conclusions

13. There is now a broad consensus that investment scale delivers real investment performance improvements which would tend to reduce deficits. Across Wales, based on £11.8 billion of assets, an improvement in net of fee investment performance of £45 million a year is a reasonable target to work towards. Achieving an improvement of this type is financially more important than rearranging administration arrangements. New investment arrangements could be established within 24 months.

14. In Wales, investment scale can be delivered using different options. We have considered either merging the eight existing LGPS funds in Wales to form one LGPS fund for Wales or by establishing or using a CIV. Such a CIV could be established for Wales, or the eight existing LGPS funds in Wales could participate in CIV(s) for England and Wales if the DCLG either endorses or directly facilitates such arrangements. In practice, it would be prudent to keep DCLG informed on intentions and progress towards a CIV for Wales.

15. The option of merging to form an intermediate number of LGPS funds for Wales should be disregarded from an efficiency perspective. A case exists for continuing with the existing eight LGPS funds; a case exists for merging them all to form a single LGPS fund for Wales. From our analysis, there is no case predicated on investment efficiency (the largest source of efficiency) for an intermediate number, such as three LGPS funds or, should it be possible, across three joint committees.

16. A high level of participation is vital if a CIV is to deliver the £45 million annual performance improvement envisaged. This requires either mandation or a high level of voluntary participation to achieve investment scale. In practice, it would be expected that voluntary participation would be higher if the funds have access to good-quality information to support a business case for their individual decisions, for example information on anticipated CIV transition and ongoing costs. In the absence of a sufficient level of CIV participation, perhaps after a pre-determined time period has elapsed, only merger into a single fund will deliver the expected improvement in investment performance. Lower levels of participation would generate lesser savings. Transition and operational costs, substantially independent of participation levels, would arise if a CIV is set up in Wales. These should be a modest proportion of the full annual saving but to ensure that money is well spent, there would need to be a strong drive to achieve high participation if this option is taken forward rather than fund merger.

17. There is a legal issue associated with mandation to use a CIV. In essence, there is a European directive that can be interpreted as prohibiting government from directing authorities on investment decisions (including participation in a CIV). Some legal opinions would, however, indicate a more flexible interpretation. We have not sought our own legal opinion on this issue.

18. There is also a legal issue associated with merging LGPS funds. In essence, merger would require either DCLG-sponsored secondary legislation or the transfer of legal competence in this area to the Welsh Government. The Governance and Standards Sub-Committee of the SAB will need to consider legal implications of establishing joint committees across funds, if this option were to be recommended for DCLG consideration.

19. One sequence of events might be to establish a CIV for Wales, with voluntary participation. This may be sufficient to achieve the scale envisaged if participation was at, or close to, 100 per cent. In the event that participation was lower after a pre-determined time period has elapsed, mandation (of CIV use) could be sought or merger (of LGPS funds) actioned, subject in each case to resolving the relevant legal issues and administration issues in the case of merger.

20. Reorganisation of the LGPS in Wales can be pursued before, at the same time as, or after reorganisation of the unitary authorities. They are substantially independent decisions.

21. The key impact of reorganising the unitary authorities is to amalgamate current funding positions created over a long period of time in the sense that each new unitary authority would inherit both the assets and liabilities of the relevant predecessor unitary authorities. A process of averaging would take place. In most, but not all, scenarios researched the averaging has a modest impact.

22. Mergers between LGPS funds would not have this type of averaging impact. The assets and liabilities of each unitary authority would carry over into a single LGPS fund for Wales, and they could continue to be separately identified and measured to derive a funding level for each unitary authority. Coherent actuarial assumptions would, however, be expected if there were to be a single LGPS fund. The definition of the actuarial approach would require care, not least to maintain acceptable contribution stability between the results of the 2016 and 2019 actuarial valuations (assuming the merger was concluded by 2019-20). This checking of the overall actuarial approach would not affect the 'notional ownership' of the assets and liabilities by each unitary authority.

23. These conclusions are reached ahead of the 31 March 2016 actuarial valuations of the LGPS funds, which will derive new employer contributions payable from April 2017. Given recent market conditions, there is an underlying concern that the contributions, measured either as a proportion of unitary authority budget, or of council tax receipts, will tend to increase. Actions consistent with these conclusions can help to contain such increases, but care would be needed to mitigate against possible local adverse effects, even if they would be modest.

Recommendations

24. In our view, there is a strong case for the Welsh Government and the Welsh Local Government Association to support the establishment of a CIV for all eight funds in Wales. This approach would incur start-up costs, and the Society of Welsh Treasurers should be asked to provide analysis of those costs.

25. A Wales CIV could be established over the next two years, in advance of local government reorganisation (although, as noted above, the timing is independent) on the assumption of appropriate commitment by relevant stakeholders including the funds themselves/existing administering authorities.

26. Following local government reorganisation, participation in the CIV, by the eight administering authorities responsible for the funds, should be reviewed. If participation in a CIV was not at an optimal level to secure the maximum investment returns after a pre-determined time period, then the Welsh Government should consider merging the existing eight funds into a single LGPS fund for Wales using an appropriate legal channel. The two channels available for this to happen are through DCLG passing secondary legislation (regulations for mergers) or the transfer of such legal competence to the Welsh Government to pass regulations.

27. There is also a strong case for considering further either an earlier merger of the eight funds in Wales or, if available, a joint committee approach. These possibilities might create more investment efficiency than a Wales CIV but are not within the sole control of the Welsh Government. The latter would depend on recommendations by the SAB and both would depend on decisions by DCLG.

28. These recommendations have to be considered in the light of the wider considerations taking place. For example, DCLG's forthcoming response to the consultation, which may result in optional or mandatory participation in CIV(s) that might be established across England and Wales and advice given by the Governance and Standards Sub-Committee of the SAB, which may open up a joint committee route for the eight funds in Wales. Accordingly, given the state of flux shortly after the General Election, these recommendations are highly time sensitive and actions should be taken only after further consideration.

Part 1

Scope, issues and initiatives

Scope

29. This review concerns the structure and costs of the LGPS in Wales and how these may be improved. The overall approach of the review is broadly as follows:

- Establish a baseline by considering the main issues affecting the efficiency and cost effectiveness of the LGPS across England and Wales. The issues can be categorised under four headings: deficit measurement and management; investment performance; governance arrangements; and the administration of and operations of the LGPS funds.
- Identify the initiatives and actions taken to address these issues over the last five years. The position over England and Wales is relevant since the LGPS as a whole, and the individual 89 LGPS funds in England and Wales, are presently regulated by the DCLG. Summarise research into the identified issues and consider its relevance to decisions affecting the LGPS in Wales.
- Given that research points to investment performance being the largest source of potential efficiency gain, focus on this aspect, in particular presenting and reviewing analysis on the relationship between investment performance and the scale at which assets are managed.
- Quantify the potential financial benefits likely to be achieved by efficiency initiatives in Wales, using recent actuarial funding information, administration cost and investment cost data for the eight Welsh LGPS funds. Initiatives such as fund mergers and the collective management of assets without fund mergers have been examined. Outline the actions, including where applicable any legislative change to provide legal competence to the Welsh Government, needed to implement such initiatives.
- Consider how conclusions may be affected by any proposals to merge the 22 unitary authorities in Wales.

30. The benefit structure of the LGPS and rates of member contributions, two primary drivers of its affordability to employers, are out of scope. Benefits and member contributions will in future be connected to new cost-capping regulations intended to maintain the long-term affordability of the LGPS.

31. The benefit structure of the LGPS was altered recently, in April 2014, in line with the 2011 recommendations of the Independent Public Service Pensions Commission (the Hutton Commission). This new benefit structure was implemented one year before other public service schemes implemented their new structures. Now that this complex transition has been completed, increased focus across England and Wales is being directed to efficiency and cost-effectiveness issues.

32. The review has included consultation with a range of stakeholders to seek their views. Stakeholders consulted have included the Welsh LGPS fund pension managers, the Welsh Local Government Association, the Society of Welsh Treasurers, and trade unions.

Issues affecting efficiency and cost effectiveness

33. The major issues affecting the efficiency and cost effectiveness of the LGPS across England and Wales fall under four main headings. We provide an overview of each of these below.

Deficit measurement and management

34. Deficit measurement and management is about how funding valuations are conducted and how LGPS funds agree appropriate contribution levels with their employers. To date, there has been limited guidance from DCLG on best practice, but the SAB for the LGPS in England and Wales has identified the issue as a workstream to be pursued in 2015.

35. Specific issues have emerged in relation to wide divergence of actuarial assumptions used by the four actuarial firms that advise the LGPS funds: the challenge of comparing LGPS funds on a like-for-like basis, the use of long recovery periods, a lack of transparency of how contributions agreed with employers are ultimately determined and of funding positions at employer level.

36. There has also been considerable variation in the approach taken by funds to consider employer covenant risk. Given their taxpayer backing, the unitary authorities can be seen as ultimately having a very sound covenant, despite severe budgetary constraints. Other employers in the LGPS, such as housing associations, colleges and charities, have varied and sometimes more questionable ability to maintain contributions.

37. Deficit management is particularly closely linked to investment performance in the LGPS, given that the benefit structure cannot easily be varied and that the LGPS funds are open to new members and continuing accrual of benefits. This is not the situation with most private sector occupational pension funds. It places an extra premium on good long-term investment decisions.

Investment performance and efficiency

38. Investment performance and efficiency concerns a range of issues. These include the appropriateness of existing investment strategies of LGPS funds as long-term investors, the choice and complexity of investment management structures, investment performance and its measurement, risk metrics and measurement and investment costs and their transparency.

39. Questions have arisen over the cost effectiveness of balanced management in terms of investment returns achieved net of costs. Evidence has also emerged in relation to scale. For example, smaller funds can be charged higher investment fees than larger funds, and other funds with internal management deliver better performance.

40. Some of the research concerns how assets of different funds could be managed collectively for both listed asset classes and alternatives such as infrastructure. Collective management can be consistent with individual funds retaining asset allocation decisions.

41. Some funds – not specifically in Wales – have been criticised for having an inappropriate short-term outlook in terms of measuring performance and rotating managers. This is an example of investment management linking with governance issues.

42. Investment management provides the greatest potential for improved efficiency and cost effectiveness. Assets under management in the eight LGPS funds total £11.8 billion. Thus an overall performance improvement of 0.4 per cent per annum, if it could be achieved each year, would equate to an annual £45 million approximately. (Such a level of improvement is consistent with the potential savings modelled under different revised investment structures of between 0.36 per cent and 0.42 per cent in Part 3 of this report.) As another example of the importance of investment management savings, total investment management fees paid by the Welsh funds in the year to 31 March 2014 were £45 million (by coincidence the same figure as for the performance improvement above).

Governance

43. Many LGPS costs are affected by governance structures. Good structures can increase the likelihood of efficient working practices being operated and better decision making for individual LGPS funds.

44. A range of governance issues were highlighted by the Hutton Commission in 2010-11. A consequence was the Public Service Pension Schemes Act 2013 which has led to a new regulatory regime commencing from April 2015. Compliance with the regime will have its own costs although it has the potential to produce efficiencies elsewhere.

45. Issues have arisen around the knowledge and length of tenure of councillors serving on pension committees, which are the decision-making bodies of the LGPS funds. These, and a tendency to over-rely on, and lack of challenge to, advisers (actuaries and investment consultants in particular) by pension committees, are highly relevant to investment efficiencies.

46. Other issues are the management of conflicts of interest, and sometimes lack of scrutiny of adherence to regulations laid down by the DCLG.

Administration and operations

47. There has been increasing scrutiny over the last five years as to why different funds have different administration costs and expenditure on advisers and the scope of services performed by individual funds' pension teams. Each fund generally has its own administration team although there have been examples of collaboration to share team resources across neighbouring funds (eg, Devon and Somerset).

48. Individual LGPS funds have had to cope with expanding legislation, including the introduction of auto-enrolment requirements which commenced in 2012, and the new LGPS Career Average Revalued Earnings (CARE) design implemented from April 2014. The necessary changes to IT systems and processes have been achieved, a significant challenge met generally with little additional resource.

49. Emerging issues which have had, or will have, an adverse impact on management of administration costs include:
    - the growing number of employers, recently reaching 10,000 in England and Wales (but more prevalent in England than Wales due to establishment of academy schools);
    - increased complexity of benefit design and disclosure with the introduction of the CARE design;
    - increased complexity of transfers rules and operation of Freedom and Choice legislation from April 2015;
    - new standards of record keeping under the Code of Practice from the Pensions Regulator from April 2015; and
    - increased annual data submissions to the SAB and triennial submission to the Government Actuary's Department.

50. A beneficial development in recent years has been funds addressing the high costs of procuring advisers by setting up framework agreements for various services with other funds, including the national frameworks.

51. Total administration costs of the eight LGPS funds in Wales in the year to 31 March 2014 were £10 million. Although a substantial total, this relates to 312,000 members, and so is modest on a per capita basis. It demonstrates that the potential for efficiency and cost effectiveness on administration is less than for investment change: if a substantial percentage saving of say 20 per cent were to be achieved on administration costs, this would be £2 million a year.

LGPS initiatives and actions since 2011

52. Exhibit 1 summarises the key initiatives and actions taken to address efficiency in the LGPS over the last five years. These included central (DCLG or SAB led) and local fund actions.

Exhibit 1

Initiative/action	Timing	Affected issues
English South West Funds Framework and National Framework for consultancy services commenced.	2011 and 2012	Deficits/ investment/ administration
Work commences to establish London funds CIV for 32 borough funds with potential assets of £24 billion. This is to be established as an authorised collective scheme, an EU-compliant structure, recently formulated under UK legislation.	2013	Investment
LGPS investment regulations amended to increase maximum permitted percentage holdings in contributions to partnerships, and thus widening access to infrastructure investments.	February 2013	Investment
'Call for Evidence' on the future structure of the LGPS published by DCLG and the Local Government Association.	June 2013	All
SSAB established in response to Public Service Schemes Pensions Act 2013.	July 2013	All
DCLG consultation closed on opportunities for collaboration, cost savings and efficiencies for LGPS. This consultation excluded the possibility that DCLG would press for mandatory mergers. The response to consultation is not expected until June 2015 or later.	July 2014	All
Launch announcement for £0.5 billion infrastructure fund partnership (West Midlands LGPS fund and LPFA).	January 2015	Investment
Pensions Regulator publishes Draft Code of Practice on governance and administration.	January 2015	Administration, governance
Shadow Board guidance on operation of local pension boards.	January 2015	Governance
Shadow Board letter to funds confirming deficit management work programme, including standardised basis publication proposals, ahead of recommendations to DCLG.	January 2015	Deficit management

Initiative/action	Timing	Affected issues
Shadow Board publication of whole of scheme data and work to develop scheme metrics to identify failing funds.	Work ongoing at April 2015	All
Shadow Board Investment Sub-committee resolution to follow two-part work programme on investment fee transparency, looking at information availability under existing legislation and how legislation might be changed.	March 2015 onwards	Investment
SAB established, funded by levies, and takes over the work of the SSAB.	April 2015	All
Local pension boards in the process of being set up.	April 2015 – June 2015	Governance
The Pensions Regulator starts to have responsibility for aspects of public service schemes governance.	April 2015	Administration, governance
London funds CIV expected commencement date.	Late 2015	Investment

Part 2

Review of actions and papers

Analysis of effect of recent and current LGPS initiatives and papers

53. In this section, we comment on both the list of actions and initiatives previously summarised in Part 1 and the research documents considered for this review. The latter are listed in Appendix 1 which also contains one-page summaries of each.

Deficit management

54. More consistency and transparency of approaches to setting contributions for the 2016 valuation is generally anticipated. These expectations anticipate publication of best practice guidance by DCLG, advised by the SAB.

Investment

55. The overall impact of the investment regulations appears to have been increased activity on the collaborative establishment of infrastructure funds.

56. The impact of the DCLG announcement that it is not intending to impose mandatory mergers has been, perhaps as intended, to increase the significance of other collaboration and of CIV options in particular.

57. However, the context within which these would be operating will only be clear once the DCLG responds to its consultation on efficiency, which closed in July 2014. Major unknown aspects of the response are as to:

- whether a top-down CIV model will be imposed over England and Wales, or whether local initiatives to establish CIVs will be encouraged;
- the degree of compulsion or encouragement applied to the 89 funds to use CIVs; and
- the emphasis on the use of passive investment techniques and infrastructure investment.

58. DCLG has consistently maintained that its response will be made in due course. It is now expected at some point after June 2015. Ministers then in place could be expected to influence the timing and content. The interim uncertainty may have delayed some voluntary collaborations at a local level. Despite this, the London Councils has proceeded to make tangible progress to establish a CIV, now expected to commence in late 2015. Their and other work on the best structure to establish CIVs may enable further LGPS funds to set up CIVs more quickly and at lower cost once the context is clearer.

59. Finally, there appears to have been some re-consideration of active management given the publicity in the Hymans Robertson report preceding the DCLG consultation. The Hymans Robertson emphasis on passive management drew a range of comment, including observations from active managers.

Administration and other non-investment costs

60. Some funds are pressing on with their own collaborations on sharing administration teams and setting up framework agreements for procurement of actuarial, benefit, governance and legal services.

Governance

61. It is too early to analyse how effective new pension boards and training requirements imposed by the Pensions Regulator may be in raising governance standards and promoting effective decision making.

Quantification of potential performance enhancements supported by papers on the LGPS

Analysis of net investment performance

62. An important part of the scope of this report is to review past literature on the relationship between investment performance and the scale at which assets are managed. PwC carried out such a review encompassing different published papers, data sets and analysis techniques which should help establish a consensus and evidence-based view. The key findings of the papers considered of most relevance to the Welsh LGPS funds report are summarised in Appendix 1. The investment performance findings were collated and are summarised in the Exhibit 2.

63. Inevitably, different papers commented on different aspects, but the overall consensus was that, on average, larger pension funds including LGPS funds specifically have performed better than smaller funds, and that the factors causing this will have persistence.

Exhibit 2: Sources of net investment performance enhancements

Reference	Report	Overall commentary on improved gross performance resulting from greater scale	Lower fees from increased scale	Benefits from internal management	Lower fees from passive	Lower cost alternatives approach	Lower asset turnover	Better governance premium	Better access to alternatives	Better diversification of asset class and manager
1	Scottish Pathfinder	Little evidence presented.	0.08%							
2	PwC Wales 2010	Higher and more consistent performance noted.	0.02% to 0.04%							
3	Scottish Pathfinder II	Concluded no hard evidence looking at eight-year period – other analysts differed from same data published by Audit Commission.	0.08%							
4	PwC London 2012	0.35 per cent pa is achievable after comparing average London fund (less than £1 billion) with large funds (£5 billion plus) over different length periods 2001 to 2011.	0.15%							
5	CASS Lon Governance				Yes	Yes	Yes	Yes	Yes	
6	UNISON	1.0 per cent pa for 2008-09 comparing Wales actual with large funds (£8 billion plus).	0.2%					Yes		Yes

Reference	Report	Overall commentary on improved gross performance resulting from greater scale	Lower fees from increased scale	Benefits from internal management	Lower fees from passive	Lower cost alternatives approach	Lower asset turnover	Better governance premium	Better access to alternatives	Better diversification of asset class and manager
6	APG	APG: 1.20 per cent pa outperformance of largest UK funds over 2002 to 2009 compared to average UK fund.	Up to 0.3%					Yes		Yes
6	Stonefish		0.2%							
7	SWT 2013	Hymans Robertson evidence: 0.9 per cent pa over 10 years to 2011 comparing £1 billion fund to £5 billion fund.	Yes	Yes				Yes		Yes
7	SWT 2013	State Street (WM): 0.6 per cent pa outperformance of largest UK funds compared to average UK fund over 10 years to 2013.								
8	State Street	0.6 per cent pa over 10 years to 2013 – and 0.22 per cent pa suggested as realistic future target.	0.15%	0.30%	0.15%	Yes	Yes	Yes	Yes	Yes

Reference	Report	Overall commentary on improved gross performance resulting from greater scale	Lower fees from increased scale	Benefits from internal management	Lower fees from passive	Lower cost alternatives approach	Lower asset turnover	Better governance premium	Better access to alternatives	Better diversification of asset class and manager
9	Hymans Robertson 2013	Evidence not presented on scale. Potential savings from other investment management restructuring (see later columns) noted to be achievable without significant reform/merger.			0.12%	0.13%	0.11%	Yes	Yes	Yes
10	London Councils	0.5 per cent pa comparing average London with large funds (£5 billion plus).		Yes		Yes		Yes	Yes	

64. Some of the factors were behavioural: larger funds tend to have better governance structures and more efficient and responsive decision-making procedures. This is the ‘governance premium’ which leads to better informed decision makers with wider and longer-term investment expertise and experience. In turn, this enables them to challenge investment consultants more readily, and to appreciate the benefit of longer-term strategies and lower turnover – buying and selling – of individual stocks.

65. Another major factor was the possibility of internal management by larger funds and wider, lower-cost access to alternative asset classes.

66. Many of the papers cited evidence of the bargaining power of larger funds to achieve lower external investment management fees. These were typically reported as historically being around 0.2 per cent lower when comparing funds up to £1 billion with substantially larger funds.

67. Several of the papers quoted the results of extensive numerical analysis which looked at the historical performance of either the smallest LGPS funds (of up to £1 billion) or of the average LGPS fund in comparison with the largest LGPS funds in the UK of £8 billion plus (such as Strathclyde, West Midlands, Greater Manchester and West Yorkshire). These typically indicated outperformance of an £8 billion fund compared to a sub £1 billion fund of between 0.6 per cent and 1.2 per cent per annum over different periods of several years to 2013. Some papers suggested that around one-third of this outperformance would represent a credible and achievable estimate for the future.

68. Passive investment management is often mentioned and the Hymans December 2013 paper stresses its benefits for listed assets. It explicitly suggests a saving of 0.12 per cent resulting from fees being lower than for active management, and it also identifies 0.11 per cent resulting from lower asset turnover, which passive management almost automatically achieves.

69. In summary, PwC’s observation was that a net of fees investment performance enhancement of between 0.4 per cent and 0.5 per cent a year is a credible target estimate for a UK pension fund of £1 billion switching to being managed collectively as part of a £10 billion fund, based on the evidence reviewed. The broad split would be 0.2 per cent to 0.3 per cent from better gross returns and another 0.2 per cent from reduced investment expenses.

70. This observation has been used in the modelling by PwC of potential savings that might be realised by the Welsh funds should they pursue alternative investment structures and taking into account their existing sizes, which range from less than £1 billion to just over £2 billion. These structures are considered in Part 3 of this report using the modelling results set out in Appendix 2.

71. Percentages in each row normally add up to indicate an overall suggested improvement in a given report (references 8 and 9). All percentages are annual, applicable to assets under management.

72. Looking at columns, however, one report might put one label on a certain effect, whereas another report uses a different description of a similar effect. An example would be lower fees from increased scale and lower fees from passive management. It is not always possible to add a saving from one report to a differently labelled saving in another report.

CIV cost offsets

73. PwC provided a high-level review of the costs expected to be associated with achieving enhanced investment performance by using a CIV.

74. The only paper in the public domain on the costs of establishing and running a CIV is the London Councils update. Exhibit 3 summarises its estimates. These are based on building an operator for the CIV, rather than renting an operator (see Appendix 5).

75. A range is given depending on whether the monies transferred to the CIV are closer to £5 billion or £24 billion from a maximum potential sum of £24 billion.

76. The costs quoted are relatively modest as offsets by comparison with the enhancement to net investment performance to be sought via the use of a CIV.

Exhibit 3

Type of cost	London Councils
Establishment costs	0.007 per cent to 0.028 per cent or £1.4 million to £1.7 million
Annual ongoing costs	0.055 per cent to 0.025 per cent or £2.7 million to £6.1 million
Assumed fund size under management	£5 billion to £24 billion

Part 3

Analysis of different structures

Introduction

77. In this section, we examine some plausible structures for delivering increased scale in investment, to achieve enhanced net investment returns. Specifically, we examine:

- merger of the eight LGPS funds – either to three larger LGPS funds or a single LGPS fund for all of Wales; and
- the use of a CIV – either to establish a single CIV for Wales or to participate in CIVs that might be established across England and Wales in response to a clear DCLG decision on these.

78. We make estimates of the annual investment improvement arising under these specific structures. The modelling of these estimates is set out in detail in Appendix 2 of this report and is based on relevant research papers reviewed individually in Appendix 1 and commented on collectively in Part 2. The key parameter for the modelling is the estimated improvement in the net of fee investment performance as assets are managed at a greater scale. These are summarised in Exhibit 4:

Exhibit 4

Starting individual fund asset size	Move to £10 billion – £25 billion collective asset size: estimated net investment saving*	Move to over £25 billion collective asset size: estimated net investment saving*
Under £1 billion	0.5 per cent	0.55 per cent
£1 billion to £2 billion	0.4 per cent	0.45 per cent
£2 billion to £5 billion	0.3 per cent	0.35 per cent

* 'Net' means net of investment management expenses/fees. Any transition costs or ongoing costs associated with collective asset management would serve to offset these savings.

A majority (five of the existing eight) of the Welsh LGPS funds are in the middle asset size group above, one is in the smallest group and two are in the largest asset size group.

Maintaining the status quo

Potential savings

79. Clearly there are no potential scale driven investment performance savings to be realised by continuing with the existing eight LGPS funds and their investment management structures.

80. There are some potential savings that do not necessarily require scale. In particular, the Hymans review and the State Street review provide evidence in relation to enhanced net of fees performance from switching active management to passive management of 0.12 per cent to 0.15 per cent. Recent SWT work has also identified potential savings from joint procurement.

Costs and risks

81. The risks of taking no action for the Welsh funds in the short-term include potentially more difficult deficit management negotiations for LGPS employers in Wales and criticism from representatives of local and central government taxpayers for not seeking out efficiencies.

82. Future risks would come from the UK government or DCLG, supported by its SAB, potentially intervening to impose a new structure which could otherwise have been avoided by earlier action.

Mergers in Wales

83. There have been no voluntary mergers between LGPS funds to date and DCLG has ruled out mandatory mergers of funds under the recent UK Coalition Government.

84. In this section, we consider the possibility of either voluntary mergers or a merger mandated by the Welsh Government in the event that it obtained legal competence in the area.

Potential savings

85. The modelling in Appendix 2 indicates that merging down from eight funds to three funds would produce a net investment saving but only a relatively modest annual estimate of £14 million (being approximately 0.12 per cent of total assets).

86. However, the estimated annual net investment saving for a full merger to establish a single fund for Wales is much higher at £43 million (or circa 0.36 per cent of fund assets). There would be no need to establish a Wales-only CIV under this structure. Unlike the savings considered via use of CIVs on a voluntary basis (see below), there is no dependency for this savings estimate on a participation or 'take up' rate by the funds.

87. So the option of merging to an intermediary number of funds (eg, three) is not supported by a case for efficiency given that investment savings are the biggest source of efficiency savings.

88. At the end of Part 4 we note how a coherent single actuarial approach to funding would require development in the event of there being a single fund.

Costs and risks

89. There is a legal issue associated with merging LGPS funds. In essence, merger would require either DCLG-sponsored legislation in Westminster or the transfer of legal competence in the area to the Welsh Government. One or the other can be requested but, even if agreed, there is a clear time implication.

90. The process of mergers is anticipated to take at least one year longer than CIV establishment and perhaps considerably longer. The overall process would be dependent on how quickly the necessary legal changes took to be implemented.

91. There is more transition cost uncertainty on mergers since there is no precedent (whereas London Councils has published full information on their transition costs for CIV establishment).

Establishing a CIV for Wales

92. Given DCLG's stance on collaboration to date, the possibility of mandatory participation in CIVs which are yet to be established remains open.

93. In this section, we consider the possibility of the establishment of a CIV in Wales which would initially be available on a voluntary basis to Welsh funds only. This is similar to the approach being implemented for London LGPS funds. A high level of participation by London LGPS borough funds (30 of 33) is anticipated, but there is less clarity as to the proportion of assets that will be invested.

Potential savings

94. The modelling in Appendix 2 shows that the estimated annual net investment saving is £43 million ie, the same figure as under full merger in the previous sub-section. However, this is conditional on full take up of the CIV by all the LGPS funds (whether the original eight or a lower number after any fund mergers).

95. A high level of participation is vital if a CIV is to deliver the estimated saving. This requires either mandation or a high level of voluntary participation to achieve investment scale (or participation from outside Wales). In the absence of a sufficient level of participation only merger into a single fund will deliver the expected improvement in investment performance. Lower levels of participation would generate lesser savings.

Costs and risks

96. There is a legal issue associated with mandation to use a CIV. In essence, there is a European directive that can be interpreted as prohibiting government from directing authorities on investment decisions (including participation in a CIV). Some legal opinions would, however, indicate a more flexible interpretation. We have not sought our own legal opinion on this issue.

97. Transition and operational costs, substantially independent of participation levels, would arise if a CIV is set up in Wales. These should be a modest proportion of the full annual saving. Looking at the London CIV estimates quoted in Part 2 and Appendix 1 (Part 10), the transition costs might be of the order £1.5 million and ongoing costs of the order £3 million. These are broad estimates only which would depend on how exactly the CIV is established. Transition costs and timings may also depend on exit clauses of existing investments held by the Welsh funds since the transition process would need to seek to avoid exit penalties.

98. The process of CIV establishment is anticipated to take up to two years.

99. There is more transition cost and operation cost certainty on CIVs through the London precedent.

Potential CIV structure

100. In Appendix 5 of this report, PwC has provided a diagrammatic of how a CIV might be structured for the Welsh funds. The overall structure shown is an Authorised Contractual Scheme or ‘ACS’ for short. The participating LGPS funds would hold units in the ACS under co-ownership. Please refer to the explanatory text in the appendix for more detail.

Using pre-established CIV(s) for England and Wales when available

Potential savings

101. The modelling in Appendix 2 indicated that the estimated annual net investment saving is £49 million (or circa 0.42 per cent of fund assets). This is £6 million higher than the estimated saving achievable from mergers into a single fund or via 100 per cent take up of a Wales CIV. The reason for the increase is the assumption that the Welsh LGPS fund could get further economies of scale by joining a CIV operating across England and Wales which had collective assets under management which were ‘ultra-large’ ie, £25 billion or more for whom some evidence has been presented as earning higher net investment performance than even ‘large’ funds classified for LGPS purposes as being of a lower scale ie, circa £10 billion.

102. However, there is no short-term prospect for this option becoming available since DCLG’s intentions are not yet known and nothing is expected to be announced until after June 2015 at the earliest with a new UK Government in place.

Costs and risks

103. The legal issues here will be dealt with by DCLG in respect of all English and Welsh funds. There is no need for the Welsh Government to consider specific legal issues for Welsh funds.

104. There would be no transition costs unless one or more Welsh funds were somehow involved in the establishment of an across-England-and-Wales CIV. Ongoing costs would be expected to arise for participation in a pre-established CIV.

105. Both the costs and terms of membership (eg, ability to vote on the overseeing investment joint committee) are likely to differ between founding CIV members and ordinary participating CIV members. This could be seen as a drawback of this type of CIV since there would be less or no Welsh control over CIV management in comparison with the Wales CIV governance model with representation for all Welsh administering authorities illustrated in Appendix 5 of this report. However, all types of CIV should allow continuation of control over investment strategy by administering authorities.

Use of CIV then subsequent potential merger

106. One sequence of events might be to establish a CIV for Wales, with voluntary participation. This may be sufficient to achieve the scale envisaged if participation was at, or close to, 100 per cent. In the event that participation was lower, mandation (of CIV use) could be sought or merger (of LGPS funds) actioned, subject in each case to resolving the relevant legal issues.

107. If merger was identified as the preferred medium-term goal, then there would be little long-term point in establishing a CIV for Wales (with the associated costs). However, if merger were difficult to achieve in the short to medium term for any reason, a CIV might be a precursor.

108. Decision making around this requires a view to be taken on how soon CIVs may be made available across England and Wales. More information on DCLG's intentions in this area are expected in June 2015 or later with a new UK Government in place.

Administration savings

109. In previous sub-sections above, our modelling suggests that achieving an improvement in net investment performance of at least £43 million before relatively modest costs is a reasonable target. Achieving this is financially more important than rearranging administration arrangements as another possible source of efficiency.

Administration and investment: staffing models in Wales

110. Administration and investment management are distinct functions which could be streamlined separately in due course and have different recruitment/retention issues.

111. This report has noted that obtaining savings via investment restructuring is financially more significant than from rearranging administration. In terms of investment management roles, the vast majority of Welsh LGPS assets are currently externally managed by firms outside Wales. If a Wales CIV were established, with an operator that was built rather than rented (see Appendix 5), it would be realistic to base its staff in a single location subject to being able to attract the required investment expertise to that location. In contrast, the administration of the eight funds is carried out internally across different sites. Further work could be conducted to determine which administration roles would be more easily brought into a streamlined central administrative team and which others might be left to provide a 'local' service. Some degree of streamlining could be carried out under a move to a CIV as well as under a move to full merger.

112. There is no compelling case for any central administrative function to be located in the same geographical location as the investment management function. Accordingly, there may be flexibility on locating any central team or teams if the question arises in due course.

Part 4

Local government changes in Wales

113. In January 2014, the Commission on Public Service Governance and Delivery (known as the Williams Commission) published its recommendations. These were for the Welsh Government to implement a comprehensive programme of change to public service delivery requiring a three-to-five-year time period. This included the recommendation that the current 22 unitary authorities in Wales should be merged into larger units, no more than 12 in number.

114. We understand that the actual number of authorities is still being debated between eight and 12, that the decision is not expected until later this year ahead of Welsh Assembly elections in 2016 and that new arrangements may not be fully implemented until 2020.

115. We understand that the Welsh Government has determined that these forthcoming local government changes provide an opportunity to also consider the delivery of the LGPS in Wales.

116. There are currently eight LGPS funds in which the 22 unitary authorities participate in Wales. These are listed in Exhibit 15 in Appendix 3. The administration and management of each fund is effectively the responsibility of one designated unitary authority known as the 'administering authority' of the particular fund. As such, these authorities have a dual relationship with their fund: to manage the fund and also as a participating employer.

117. The 14 other authorities are simply participating employers: one of the funds, Powys, has no other participating authorities, but Torfaen has four other participating authorities; most funds have an intermediate number. Individual deficit numbers and contribution rates are calculated by each fund for each authority. This requires each fund to maintain a notional segmentation of assets and liabilities for each authority – as also happens for other employers in each fund, but this is not relevant to the main point here – and thus different authorities can build up different actuarial funding positions as a result of historic decisions.

Impact of merger of unitary authorities

118. The merger of unitary authorities would not directly have much impact on three of the four identified areas (investment, administration and governance) but it will have an impact on deficit measurement and management. This would be through current funding positions being averaged between merging authorities and the possibilities of moving authorities between funds. We consider each of the four issues in turn before finally commenting in this section on the interaction between this type of merger and LGPS fund mergers.

Deficit measurement and management

119. The unitary authorities would be impacted in relation to their actuarial funding position and hence associated deficit recovery contributions. There may also be some impact on their contributions in respect of ongoing benefit accrual (known as the future service rate) if, for example, the average age of employees of the merging authorities were significantly different.

120. Our illustrative analysis of the impact on contributions from the merger of unitary authorities is limited in this report to the effect on deficits, since we expect this to be greater than the effect on the future service rates.

121. A change to the funding level arises because the authorities will end up with a weighted average of the funding levels created over a long period of time of all ie, the two or three authorities which are part of each merger. For example, if authority A and authority B participate in the same fund and have pre authority merger funding levels of 75 per cent and 85 per cent, then after the authority merger the new entity will inherit both the assets and liabilities of its predecessors and so end up with a funding level between 75 per cent and 85 per cent. The new level would, for example, be 80 per cent if the authorities had liabilities of very similar size or else be closer to the previous funding level of the larger authority if unequal in size. To this extent, historic performance on managing funding deficits would be crystallised and combined. But the deficit of the new merged entity would overall simply be the sum of the previous deficits. Thus, there would be no change in the overall deficit to be managed, in the absence of any change in actuarial method.

122. In order to look at possible effects in more detail, Appendix 3 contains detailed modelling for each of the 22 current unitary authorities based on estimated funding positions at 31 March 2014. This has been derived from accounting IAS19 data published at that date for each authority. The modelling covers two purely illustrative possibilities for a reduction to nine authorities and a reduction to 12 authorities. Other scenarios are of course possible. The impact on the authorities is summarised in Exhibit 5.

Exhibit 5

Scenario	Largest deficit worsening across original authorities	Largest deficit improvement across original authorities	Total deficit impact all funds, all new authorities	Number of impacts in excess of £15 million
Reduction to nine unitary authorities (see Exhibit 17 in Appendix 3)	£20 million	£23 million	Nil in total	7
Reduction to 12 unitary authorities (see Exhibit 16 in Appendix 3)	£50 million	£50 million	Nil in total	4

123. Overall, the modelling suggests that the averaging has a modest impact on most, but not all, of the existing authorities under either scenario. It also illustrates which authorities might be expected to see an improvement or worsening in terms of the funding of their LGPS liabilities. Important points to bear in mind regarding the modelling are:

- Relative funding positions could change between the illustrative date of March 2014 and the actual merger date to form the new unitary authorities.
- The modelling is presented on a common or standardised set of assumptions. This is a notional basis rather than the basis which would actually be used by each fund actuary. Its purpose is to allow like-for-like comparisons across funds. The key assumption is the discount rate used to value liabilities. This is taken to be CPI inflation plus 3.0 per cent ie, the real discount rate is 3.0 per cent.
- The modelling does not allow for any changes to LGPS liabilities arising from authority staff leaving voluntarily or via redundancy as part of the authority mergers process. These changes could themselves be significant (either detrimental or positive) but will depend on the age and service profile of staff leaving.

Investment

124. There would be no direct impact from merger to form new unitary authorities since the investment management structures of the underlying funds would be unchanged.

125. The allocations of assets to each LGPS employer are notional, conducted by the actuaries allocating whole of fund investment returns. In rare situations where an authority moved between funds as part of a merger, transfer amounts would have to be agreed and paid.

Administration

126. Merger into new unitary authorities would have a minimal impact on administration costs. In most situations, the same administration team would be likely to continue the same roles as previously. Teams would interact with a smaller number of large LGPS employers for data collection, contribution collection and funding valuation discussions. There would also be some transitional issues to be managed.

Governance

127. There could be a slight impact on personnel elected to pension committees and boards but these are likely to be minimal.

128. There would be fewer large employers to manage within each fund, although much of the administrative complexity relates to smaller non-authority employers in any event.

Interaction with fund mergers or other collaborations

129. The forthcoming plan to merge local authorities would neither enhance nor create obstacles in relation to possible proposals to reorganise the LGPS in Wales. Reorganisation of the LGPS in Wales can be pursued before, at the same time as, or after reorganisation of the unitary authorities. They are substantially independent decisions.

130. Mergers between the LGPS funds themselves, rather than between authorities, would not have this type of averaging impact. The assets and liabilities of each unitary authority would carry over into a single LGPS fund for Wales, and they could continue to be separately identified and measured to derive a funding level for each unitary authority. A coherent single actuarial approach would, however, be expected if there were to be a single LGPS fund. The definition of the approach would require care, not least to maintain acceptable contribution stability between the results of the 2016 and 2019 actuarial valuations (assuming the merger was concluded by 2019-20).

Appendix 1

Literature review

We have selected the following key papers (Exhibit 6) on the development of the LGPS. Selection is a subjective process but, as a group, the papers reflect the breadth of the debate and trace the progress over the last six years of the major LGPS initiatives, in Scotland (the Pathfinder Project), in Wales, in London (leading to the current establishment of a CIV for London) and by the DCLG.

For each paper, we have considered the paper in its own terms, providing a summary of its approach and its conclusions. Themes around administration, deficit management and governance have been identified but the major theme is around enhancing investment performance, since achieving this is essential to long-term affordability and deficit management.

Implications for Wales have been drawn out and projected savings scaled to the Welsh context.

Exhibit 6

	Title/subject	Author	Date
1	Local Government Pension Scheme Pathfinder Project Options Appraisal	Hymans Robertson	November 2009
2	Consultancy review of Welsh Local Government Pension Funds	PwC	October 2010
3	Pensions Pathfinder Project Phase II Interim Report	Deloitte	April 2011
4	Reconfiguring the London LGPS Funds: Evaluation of options	PwC	October 2012
5	An Evaluation of Investment Governance in London Local Government Pension Schemes	The Pensions Institute, CASS Business School	November 2012
6	LGPS cost studies commissioned by UNISON	UNISON, APG, Stonefish	2010 to 2013
7	Welsh Local Government Pensions Funds Working Together (Interim Report)	Society Welsh Treasurers, Hymans Robertson	March 2013
8	Do Larger Funds Perform Better?	State Street Investment Analytics	September 2013
9	LGPS Structure Analysis	Hymans Robertson	December 2013
10	Progress report on implementing London LGPS CIV	London Councils' Pensions Working Group	February 2014
11	Deficit management in the LGPS – draft report to the SSAB	PwC	October 2014

1. LGPS Scotland pathfinder project options appraisal report – Hymans Robertson – November 2009

Background

This paper was commissioned as part of the Pathfinder Project initiated in 2007 to identify opportunities for cost savings and operational efficiencies through the adoption of shared services within the LGPS in Scotland. The objective of this report was to establish if there were any opportunities to rationalise and improve with the pathfinder organisations the management of the LGPS in Scotland including identifying potential broader benefits for the LGPS in Scotland. Three broad options were considered:

- separate funds with shared administration;
- separate funds with shared investment management; and
- rationalisation of funds.

Conclusions

Investment management

Strong arguments exist for creating larger pools of assets, achieved either through a merger of funds or by creating a common investment fund structure based on either a one-host or a two-host structure. Further work would be needed before a recommendation could be made – see April 2011 report.

Data for investment performance against fund size was for the 11 Scottish LGPS funds only, and as such had limited statistical reliability, with Strathclyde (for Glasgow) the only fund at £10 billion.

Analysis of investment management fees showed that larger funds would produce savings eg, investment management fees for three funds of £1 billion would be £9.47 million compared with fees of £7.10 million for a single £3 billion fund. This fee difference is equivalent to just 0.08 per cent. Transition costs of the order of 0.6 to 0.8 per cent of the value of the assets being moved were identified, indicating a three-to-five-year payback period.

Administration

Recommendation for a detailed investigation of cost and service levels to inform a decision on the cost/service level balance; identification of areas where consolidation of services is possible and desirable; implementation of standardised benchmarking of quality and cost of administration to allow like-for-like comparison going forward.

Key main risk identified in the four smallest funds where between two and four staff carried out the whole of the administration of the funds.

Administration costs – smaller funds were most expensive (£58 per member for Orkney), but beyond that larger funds offered more services and so were not the lowest cost. Strathclyde was £19 per member.

Implications for Wales

There is little evidence from this early review of larger funds producing significantly better returns net of fees. There is some consistency in the administration data for this review with Welsh data in that both show variation of administration costs according to type of region covered by a fund.

2. Consultancy review of Welsh Local Government Pension Funds – PwC – October 2010

Background

The report was commissioned by the Pensions Sub Group of the Society of Welsh Treasurers to identify ways in which the eight LGPS funds in Wales could operate more effectively together, particularly in their investment and administration arrangements.

Conclusions

Investment management

Analysis of data underlying the July 2010 Audit Commission report on English LGPSs suggested that funds under £1 billion had delivered mixed results, whereas funds above £1 billion had typically achieved a higher and more consistent performance over the eight years to 31 March 2009.

Looking specifically at fees, four alternative investment models were identified and cost-saving estimates made (Exhibit 7). Savings were quoted after deducting annual ongoing costs and an estimate of transition costs:

Exhibit 7

Model	Estimated annual savings (in first year)
Shared procurement	£2 to £3.2 million
Shared procurement with oversight	£1.6 to £2.8 million
Collective investment funds	£3.2 to £4.4 million
Merger of fund assets	£2.7 to £3.9 million

Administration

Three alternative operating models were identified and cost-saving estimates made. The largest possible saving was suggested to be £2.1 million if there was a single merged administration entity, in one or more locations, which might be implemented with or without merging the funds themselves.

Deficit management

The eight funds were examined on a common actuarial basis to strip out the effect of differing assumptions on funding, to enable a consistent comparison. On a common basis, funding levels and deficits varied significantly, but it was more challenging to understand the effect on contributions of merger, given that the actuaries aimed to achieve stability in contribution rates in different ways.

Governance

The governance arrangements and levels of input from different groups of stakeholder varied from fund to fund. Members had no direct representation on the main governance panels or committees, and participating employer representation was varied.

Governance after any merger should address these points, and a possible model is that used by the Northern Ireland Government Officers' Superannuation Committee (NILGOSC), which administers the single LGPS for Northern Ireland.

Next steps after this paper

The Pensions Sub-Group of the SWT believed that the PwC report was important in that it established a 'prima facie' case to look further at the organisational structure of the Welsh LGPS, with the potential to improve efficiency and service standards. The SWT followed up with further work towards an evidence-backed outline business case in the 2013 report on Working Together and the associated consultation.

3. Scotland Pensions Pathfinder Project Phase II Interim Report – Deloitte – April 2011

Background

Deloitte was appointed to carry out the research required under Phase II of the Pathfinder Project and to identify appropriate recommendations to improve the administration, investment and governance of the LGPS in Scotland. The options defined for consideration were retaining the current 11-fund structure or merger of the current 11 funds into one, two or three future funds, split broadly by geographical area.

Conclusions

Merger of the current 11 funds into one, two or three future funds should not be progressed due to the absence of a clear business case for merging funds. There were a number of improvements which should be progressed.

Investment management

There would be limited savings from moving from the current structure to one, two or three larger funds: less than £2 million pa, being less than 0.1 per cent of total assets in Scotland of £25 billion.

The report considered whether investment scale improves performance, and concluded that there was no hard and fast evidence to this effect. In support of this, it quoted an Audit Commission 2010 report which concluded that 'there is little evidence to suggest a relationship between fund size and investment performance over the last eight years, either in higher investment returns or lower volatility'. Data underlying this conclusion has been interpreted very differently by other analysts.

Administration

Variation in administration costs was modest and the average cost per member was £21, comparing favourably with the average for LGPS funds in England and Wales. Four options were considered:

- **Maintain current arrangements:** not recommended.
- **Maintain current arrangements with a revised approach to delivery:** recommendations to develop and implement standard services and service levels to improve service delivery and consistency; establish which non-core services should be offered, to be charged for separately at an agreed schedule of costs; and explore further opportunities for cost savings later.
- **Merge administration services to one, two or three centres:** rejected, since no consensus on potential host authorities, the cost of developing new operating models and the uncertainty of cost savings. However, small fund administration mergers should be considered to mitigate key main risk.
- **Use an external provider:** recommendation to transfer all administration to the Scottish Public Pensions Agency (SPPA) to be considered further in due course.

Governance

Recommendations were that model terms of reference for LGPS pensions committees in Scotland should be developed to consistently define the role and responsibilities of pensions committees. Once developed, they should be adopted and implemented by all pensions committees, and membership of pensions committees should be extended to include representatives of other employers, members and external professional representatives.

Implications for Wales

Implications for Wales seem limited. This 2011 report confirmed a growing consensus in Scotland to hold back from fundamental reform of LGPS operations, instead taking forward incremental change.

The case for cost savings by merging administration functions in Wales may be somewhat stronger for Wales than for Scotland, if this is looked at in future, given that the Welsh average lies somewhat above that for England and Wales overall in both 2010 and 2014. The Scottish average lay below (at least in 2010).

4. Reconfiguring the London LGPS Funds: Evaluation of options – PwC – October 2012

Background

This paper evaluated evidence that the individual London LGPS funds could make efficiencies by working more closely together. With the exception of the LPFA, the 34 funds are individually small, typically having assets in the range £0.5 to £0.8 billion, organised at a borough level. In aggregate, £24 billion of assets were under management.

Four types of structure with the potential to deliver financial benefits were examined, against five challenges identified by the Society of London Treasurers, relating to:

- investment governance;
- investment asset allocation;
- the linkage between local accountability and local taxation;
- statutory responsibilities; and
- the political and managerial ownership of decisions.

Conclusions

The paper presented evidence that larger funds (eg, Strathclyde, Manchester) had historically outperformed smaller LGPS funds (such as many but by no means all of the London borough funds) and identified potential savings of £120 million a year, based on performance and fee improvements combined of 0.5 per cent per annum, applied to the £24 billion asset base.

The two recommended structures were:

- A CIV for London. The paper left open the question as to whether use of the CIV would be mandatory or encouraged in order to achieve the high participation required to make the maximum savings. It was clear that asset allocations would continue to be chosen by boroughs.

- The other structure thought to meet the SLT challenges, but not taken forward, was a London framework fund. This would have gone further than a CIV by creating a single legal framework for all London LGPS funds, handling many operational matters on a collective basis, effectively a merged fund. Boroughs would have retained the power to choose asset allocations, and their separate funding levels and contribution rates/ negotiations would have been preserved, subject to a coherent overall actuarial approach.

The two structures not recommended as they did not meet the SLT challenges were variants of the London framework fund:

- one variant would have been a common investments merger, which would have removed borough autonomy on asset allocation decisions; and
- the other, a full merger, would have gone further with standardised contributions by all boroughs.

Next steps after this paper

The London boroughs have taken forward one of the four structures: a CIV to centralise much of the boroughs' investment responsibility into a central entity, charged with delivering a range of well-defined, best-in-class, pooled investment funds in a range of asset types.

Scaling to Wales

With almost £12 billion assets in the eight Welsh funds, the corresponding investment improvement of 0.5 per cent would be £60 million each year. However, since most of the eight Welsh funds start from a somewhat greater scale, investment savings would be correspondingly less.

5. An Evaluation of Investment Governance in London Local Government Pension Schemes – The Pensions Institute, CASS Business School – November 2012

Background and research

The paper aimed to establish whether there was a fundamental problem in respect of investment governance of London LGPS funds. It also sought to identify areas that might be considered in a full benchmarking study of this issue as originally recommended by Lord Hutton in 2011.

Research utilised publicly available information on funding and investment, using pension committee minutes. Interviews were held with various fund stakeholders (councillors on pension committees, pension and s151 officers, treasury and investment staff). The interviews preserved anonymity.

Conclusions

The paper concluded that overall London LGPS funds have suffered from a lack of a strong overarching governance framework. The authors stated that their research identified serious weaknesses in many of the 34 funds. To recap, these are small funds, almost all with assets in the £0.5 to £0.8 billion range.

Deficit management

Problems identified included poor or inconsistent reporting of key aspects of funding and investment strategies. These included the discount rate used to value the liabilities, the investment performance assumption for a valuation deficit recovery plan and the length of the recovery plan.

The paper claimed evidence of poor deficit management via 'shopping around' for favourable assumptions and use of repeated extension of recovery plan lengths, both likely to reduce short-term contributions, so that larger contributions would be more likely in the future.
The paper describes this forcefully as 'a ticking time-bomb for London council tax payers and very likely for national tax payers too' requiring urgent action.

Investment governance

Decision making via pension committees dominated by councillors is cited as an issue.
It is suggested that decisions are influenced as much by behavioural and political factors as by adherence to the current investment governance framework. Short tenure on committees can be a barrier to acquiring experience and expertise. Committee minutes suggest over-reliance on consultants who drive the decision-making process with insufficient challenge.

Investment strategy

The paper says there is a disproportionate focus on micro issues such as asset manager selection with frequent changes of manager leading to additional costs, with insufficient focus on overarching investment objectives and strategy. Strong preferences for active management and significant allocations to alternative asset classes lead to higher costs but without evidence of corresponding additional award.

Next steps after this paper

Although the anonymous interviewing approach was criticised by some at the time, the CASS paper built pressure towards the establishment of London CIVs.

The paper also fed into DCLG consultation, leading to alternative governance arrangements specified under regulations which came into force on 1 April 2015, including the establishment of pension boards for LGPS funds.

The Pensions Regulator has also published a Code of Practice setting out best practice on governance including training of Pension Board members and management of conflicts of interest.

6. Performance Analysis of LGPS Funds – reports by APG Groep NV and UNISON – February 2010; The Total Cost of Ownership LGPS – Stonefish Consulting – March 2013

Background

These three reports were commissioned by UNISON to provide analysis of LGPS cost and investment performance differences between funds. A summary of their findings was included in UNISON's response to the Welsh Funds Working Together Consultation in 2013. Although the reports also covered the potential for administrative savings, we summarise below only the much larger investment related savings.

Overall conclusions

The overall conclusion was that significant savings in investment performance would have been made historically by moving from smaller funds of between around £1 billion (similar to the existing average size of Welsh funds) to a fund of at least £8 billion in size which is broadly commensurate with the largest three funds in England and Wales (or of the Welsh funds combined). The analysis was for two individual years and also for approximately 10-year periods. The reported annual savings were up to approximately 0.2 per cent to 0.3 per cent in respect of investment management expenses and up to approximately 1.00 per cent to 1.20 per cent in respect of investment performance.

1. UNISON report

This was based on LGPS data analysis (89 funds in England and Wales) for the years to March 2008 and March 2009. A comparison with the three largest English funds (West Yorkshire, Greater Manchester and West Midlands) was justified on the grounds that they had asset values in 2009 of £6 billion to £8 billion which was similar to the total value of Welsh LGPS funds at that date. The total annual saving arising was circa 1.2 per cent in both years: see details in Exhibit 8.

The report also quotes several studies produced in relation to US, Canadian and European pension funds suggesting a strong trend for better performance by larger funds. It quotes research as having indicated that fund size offers advantages in relation to improved governance and control, better research and diversification and reduced management expenses from greater scale.

Exhibit 8

Larger fund potential benefit	Comment	Annual saving (2008)	Annual saving (2009)
Reduced investment management expenses	Comparison of Welsh funds with three largest English funds	0.19%	0.17%
Enhanced investment performance	Comparison of Welsh funds with three largest English funds	1.00%	1.06%

Retrospective implication for Wales: potential investment-related savings of £89 million for 2008 and £92 million for 2009.

2. APG report

This was based on LGPS data analysis (101 funds in UK) for years ending March 2002 to March 2009. As part of the analysis, a benchmark performance was constructed using market index returns by asset class. Whilst there was considerable variation between the performances of the smaller LGPS funds relative to the benchmark return over the period, the largest funds all performed better than the benchmark.

The report does not comment on why larger funds may perform better but notes that the £8 billion fund size it was asked to consider is 'not necessarily the optimum size for a pension fund. Evidence from the Netherland shows that the sophistication of investment policies increases and the risk/return profile improves with fund size.' Exhibit 9 summarises the key results.

Exhibit 9

Larger fund potential benefit	Comment	Annual saving (eight-year analysis)
Reduced investment management expenses	Focus on moving from £1 billion fund to £8 billion fund.	Up to 0.3 per cent.
Enhanced investment performance	Focus on all funds performing in line with four largest funds in LGPS over the period of analysis.	At least 1.20 per cent on average for UK funds.

Retrospective implication for Wales: the total savings over eight years for the net investment performance of the Welsh funds were calculated with a simulation running from March 2001 to March 2009 such that their performance was modelled to be in line with that of the four largest funds. The total savings were quoted to be £200 million.

The average annual savings were £5 million for investment expenses and £20 million for investment outperformance or £25 million in total or 0.5 per cent of assets. This annual saving would be expected to be higher now all else being equal given that the total value of Welsh fund assets is higher than for the midpoint of the data analysis period which was March 2005.

3. Stonefish Consulting report

This was based on LGPS analysis for 2001 to 2012 and did not consider investment performance but did consider investment expenses. Exhibit 10 summarises the key finding.

Exhibit 10

Larger fund potential benefit	Comment	Annual saving % (11-year analysis)
Reduced investment management expenses	Focus on moving to funds with lowest charges (broadly £8 billion plus funds).	0.25 per cent for Wales. C. 0.20 per cent for England and Wales combined.

Implications for Wales: applying a 0.25 per cent saving to a current asset base in Wales of £11.8 billion gives a £30 million saving just for expenses (the report quotes a saving of £24 million on assets of £9.6 billion).

7. Welsh Local Government Pensions Funds Working Together (Interim Report) – SWT, Hymans Robertson and Sackers – March 2013

Background and options considered

The Pensions Sub Group of the Society of Welsh Treasurers used four workstreams to analyse four options, without presuming that the best solution for any one workstream would be best for another:

- an 'as is' option based on the current structure of eight funds;
- 'as is' but with enhanced collaboration (joint procurement, shared working efficiencies etc);
- mid-range approaches based on merging to an intermediate number (two to seven) of funds; and
- an option based on merging to one all-Wales fund.

Findings from the four workstreams

Investment

There was evidence of potentially significant benefits of scale to be found from either merger or working collectively through a common investment approach. The potential benefits were not a direct relationship with the size but rather the result of economies of scale that together with size allow improved governance and the potential for increased return. Evidence/analysis included:

- Larger funds tending to have a combination of attributes, such as more internal and specialist resources, more internal and hands-on management, better diversification of asset class and manager, more bargaining power on fees and more responsive governance enabling speedy decision making.
- Hymans evidenced the benefit of size over the 10 years to 31 March 2011: there was significant dispersion of results around the line of best fit, but the line suggested that a £5 billion fund had outperformed a £1 billion fund by 0.9 per cent per annum over the 10 years.
- State Street (WM) compared very large LGPS funds (circa £10 billion) with the 'all-Wales' fund average, and identified outperformance in the region of 0.6 per cent per annum, with lower levels of relative risk. A more realistic target of around a third of this outperformance (0.22 per cent) would equal a one per cent of payroll reduction in employer contribution rates across Wales.
- Fees for investment totalled £22.3 million, so just a 10 per cent saving here was worth £2 million.

Governance

There is much that can be done using a collaborative approach within existing legal, organisational and governance arrangements. In contrast, merger would require a change in secondary legislation and thus engagement with both the Welsh Government and the DCLG.

Administration

Building on existing collaboration could achieve improvements in front-line service delivery, consistency and efficiency. With total administrative costs of £8 million, financial benefits identified through the administration workstream were modest but should nevertheless be pursued.

Transition costs

Both fund management fees and transition costs are significant factors but not the fundamental drivers when considering investment strategy. There would be very significant 'one-off' costs of transitioning the assets to a new organisational structure.

Key recommendations and next steps after the paper and consultation

The 'no change' option was not supported: a more proactive approach was required. At the other end of the option spectrum, the merger to a mid-range number of funds or to a single all-Wales fund were costly prospects with a long lead-in time, a loss of local autonomy and a need to change funding strategies.

Enhanced collaboration was thus seen as the area where medium-term savings could be optimised, specifically using a common investment approach. A full business case would be created to encompass the common attributes that appear to benefit larger funds with the aim of implementation thereafter.

8. Do Larger Funds Perform Better? – State Street Investment Analytics – September 2013

Section 1: do larger funds perform better?

This paper addressed the question in its title by comparing the four largest LGPS funds (Strathclyde, Greater Manchester, West Midlands and West Yorkshire, ranging in value from £9.8 billion to £13.0 billion) with the other 97 LGPS funds over the 10 years to March 2013, thus updating the SWT paper by two years. All four had higher than median return (by approximately 0.6 per cent per annum) and lower than median risk (lower volatility). So, 'at first sight, there certainly does seem to be some weight behind the size argument'.

But size is not in itself the whole answer. Nine less-complex funds (with five portfolios or less) and five internally managed funds had also performed well. Of these 14 funds, two were big four funds. Hence size in itself is unlikely to guarantee success if the structure that is in place cannot deliver the expected benefits. Key factors are strong governance and advisors advocating a slower rate of change (eg, low stock turnover).

Section 2: can anything be learned from large corporate funds?

Large corporate funds are more often managed on an internal basis. Of the 10 corporate funds above £10.8 billion that SSIA measure, eight are managed on an internal basis, a higher proportion than observed in the LGPS, even for large LGPS funds. The corporate funds had delivered superior performance at reduced risk.

Section 3: objectives for structural reform of the LGPS

There are straightforward ways to improve investment returns. First, all returns are eroded by fees, transaction costs, taxes and commissions: **long-term investment strategies** reduce the impact of three of these – transaction costs, taxes and commissions. Second, **passive management** offers the largest opportunity to reduce fund management fees paid.

SSIA states that size, of itself, will not improve performance, but it believes that larger fund size may confer a number of benefits in terms of improving returns. Primary objectives would be to realise:

- **Potential to reduce investment management costs**: larger funds can access external management at lower costs. SSIA research indicated that larger funds (above £5 billion) had costs of 0.23 per cent as opposed to smaller funds (up to £1 billion) with costs of 0.38 per cent – a difference of 0.15 per cent. Passively managed portfolios can reduce fees down to 0.07 per cent.
- **Potential to consider internal management**: this provides, first, the opportunity for active management at passive management fee levels. And, second, stronger underlying performance, which seems to average 0.3 per cent a year and arises from lower turnover. This cuts transaction costs and avoids the short termism that external managers are prone to so as to avoid their mandates being terminated: instead, underperforming stocks can be retained where value remains.
- **Potential for better governance**: size can open up asset classes, such as private equity, direct property and infrastructure opportunities. But the paper also strikes a note of caution: more responsive governance can destroy value if it focuses on manager selection – which only guarantees more spend with investment consultancies. Better governance has more to do with changing behaviours to have a greater focus on strategy relative to liabilities and a true long-term approach.

Secondary objectives would be to achieve:

- **reduced behavioural biases**, such as short-term focus and manager measurement, LGPS fund herding, excessive deference to professional investment consultants;
- **more flexible investment strategies**, with more specialist resource in house; and
- **greater infrastructure investment**, where there are strategic benefits to be gained.

Implications for Wales

Wales can achieve a £10 billion scale, but only if a high level of participation is achieved.

If internal management were pursued, there would be issues on attracting and locating investment staff.

9. LGPS Structure Analysis – Hymans Robertson – December 2013

Background

This paper was commissioned by DCLG to compare three options for structural reform of the LGPS across England and Wales. The options were to create a single CIV, to create five to 10 CIVs, in either case with mandatory use by the 89 LGPS funds being likely, or to merge the 89 LGPS funds into between five and 10 large funds, which would have implied each large fund being between £10 billion and £40 billion in size.

Conclusions

Investment management

Ultimate improvements in net investment performance totalling £660 million each year were identified. These were thought to be achievable with or without significant structural reform/merger.

In more detail, the savings for England and Wales are shown in Exhibit 11:

Exhibit 11

Investment approach item	Annual saving £m (England and Wales)	Annual saving %
More passive investment	£230 million	0.12%
Lower cost alternative assets	£240 million	0.13%
Lower asset turnover	£190 million	0.11%
Total	**£660 million**	**0.36%**

Legal

The paper contained a section on the legal impediments to establishing CIVs and merging LGPS funds, provided by Squire Sanders (now Squire Patton Boggs).

Scaling to Wales

An annual improvement of 0.36 per cent, if applied to an asset base in Wales of £11.8 billion, would be £42 million.

Next steps after the paper

The Hymans paper fed into a process that has now made clear that there will not be mergers of the 89 funds imposed across England and Wales. Another consequence was to activate a debate about the merits and demerits of passive management of listed assets that is not yet settled for the LGPS.

A consultation by DCLG, that closed in July 2014, still awaits a response from DCLG, which is now expected in June 2015 at the earliest with a new UK Government in place.

The paper also estimated timeframes and costs for establishing CIVs and for fund merger. Timeframes varied from 18 months to establish a CIV to three years to merge LGPS funds and transition their assets to larger LGPS funds.

10. Progress report on implementing London LGPS CIV – London Councils' Pensions Working Group – February 2014

Background

The purpose of the report was to update the local authorities in London on progress on the design of a CIV for the London funds in the form of an ACS, to present a business case and outline the next steps including finance for authorities wishing to participate.

Proposals

The report proposed that a private limited company be incorporated to become the operator of the ACS with each participating authority becoming a shareholder. It also proposed that a representative body of the participating authorities be established in the form of a Pensions CIV Joint Committee. The proposed structure would follow a few key principles for participation, oversight and control:

- Participation is voluntary and withdrawal is possible.
- A participating authority will be able to make asset allocation decisions.
- The authorities should have sufficient control over the operator to be assured it will be acting in their best interests. It will be able to influence its activities by owning all its share capital.
- The Joint Committee will have the power to identify and appoint key directors to the operator.
- The operator would provide regular information to authorities relevant to making investment decisions and provide regular information to the Joint Committee.

The operator would require capital over and above the assets to be invested and an amount of two to three basis points ie, 0.02 per cent to 0.03 per cent of invested assets was suggested. This can be regarded as an investment not an expense since these monies would be retained and effectively remain under fund ownership.

The business case for participation is that the savings created far outweigh the costs incurred. This is set out in Exhibit 12 which shows the maximum potential assets from London funds under management in the CIV of £24 billion and the minimum target assets of £5 billion.

Exhibit 12

Investment item	Assets under management of £24 billion	Assets under management of £5 billion
Expected savings from enhanced net of fee investment performance (annual)	£120 million or 0.5 per cent	£25 million or 0.5 per cent
Ongoing costs (annual)	(£6.1 million) or (0.025 per cent)	(£2.7 million) or (0.055 per cent)
Establishment costs including professional fees (one off)	(£1.7 million) or (0.007 per cent)	(£1.4 million) or (0.028 per cent)

The estimates are noted to take into account existing investments held by LGPS funds and that initially the majority of investment mandates are likely to be passive.

The annex to the report indicated an expected timeline of 10 months to the launch of the ACS (in February 2015) from the decisions on whether to participate (requested April 2014).

Current actions and scaling to Wales

The Joint Committee for London was established and its progress report for December 2014 indicates that 30 London authorities had agreed to participate and three had declined. The timeline for launch was extended to summer 2015 and the establishment costs were still projected to be £1.7 million with the 30 authorities expected to pay £75,000 each in costs to April 2016.

The savings for a Welsh CIV may be less than the 0.5 per cent quoted (equivalent to £60 million per annum) due to the larger average existing fund size in Wales compared to London. In terms of costs, the assets under management would potentially be up to £12 billion which is in the range considered. Costs for Wales could be lower than for London in absolute terms by re-using a proportion of the professional advisers' work done for London.

11. Deficit management in the LGPS – Draft report to the Shadow Scheme Advisory Board – PwC – October 2014

Background and research

The review was commissioned by the SSAB to inform its future policy recommendations to DCLG on better deficit management. The importance of this objective was referred to by the Board in its response to the Call for Evidence on structural reform in January 2014.

The review considered the approach taken by LGPS funds in England and Wales to deficit measurement and management at both fund and employer level. Deficits are locally managed by the 89 individual LGPS funds. The purpose of the review was to consider the development of good practices, to promote more holistic thinking and consistency of approach between funds.

As part of the research for the review, PwC interviewed actuarial and investment consultants of the four actuarial firms to the funds, and two LGPS pension managers who are members of the Deficits Working Group, which reported to the Shadow Board.

Conclusions

Deficit and covenant management

A key conclusion of the review was that using standardised assumptions to disclose and compare the deficits of individual funds would create a clear overall picture of the total deficit in the LGPS. It would show where the total resides on a granular basis and provide a foundation for actions to reduce it. Standardised assumptions would be used for comparison: individual funds would still decide their individual funding approaches in conjunction with their individual actuaries.

The review recommended that more work be carried out on the desirability of a contribution stability objective.

The review suggested a need for central guidance and direction on best practice to incentivise the active management of employer risk, since current practice was diverse. The process should be carried on a proportionate basis to keep costs manageable and cover covenant monitoring and a role for additional securities.

Guidance should be given to promoting the early recognition of exit bases for exiting employers. In addition, regulations might be amended to allow more flexible exit arrangements to be undertaken and to require a maximum level of prudence in the assumptions used.

Investment and risk management

The review considered some specific investment ideas to mitigate risk. It recommended that liability-driven investment, that can manage risk and deliver contribution stability, should be more widely understood, since it has both advantages and disadvantages.

Governance

The review noted that disclosure of funding positions on standardised bases would assist the Board with its objective of publishing balanced scorecards covering both financial and governance metrics to help identify failing LGPS funds and arrange appropriate intervention if necessary.

Next steps and implications for Wales

The Shadow Board established a new work programme for 2015 based on the review's recommendations in the run up to 2016 valuations. This was shared with funds in January 2015.

The Welsh funds should expect more scrutiny from the Board of its 2016 valuation results on a like-for-like basis with all funds in England and Wales and of their contribution setting approach for different employer groups taking into account individual employer covenant.

Appendix 2

Estimated investment gains through fund merger or the introduction of a collective investment vehicle

Background

Several of the research papers reviewed conclude that a different approach to investment, seeking the benefits associated with greater scale, would lead to higher long-term net investment returns. Scale across the LGPS in England and Wales ranges between relatively small LGPS funds, some with assets in the order of £500 million to £1 billion, up to a small number of large LPGS funds significantly above £10 billion. Even larger scale is possible: a London CIV could reach £25 billion and a national CIV £200 billion.

The papers vary in their attribution of exactly how scale would deliver higher net investment returns. This is considered in Part 2. However, many of the papers reviewed are consistent with the proposition that increased scale (ie, moving from assets under management in line with the smallest LGPS fund up to the largest LGPS fund) would improve net investment returns by around 0.4 per cent to 0.5 per cent per annum.

In this appendix, we consider net investment returns. The concept is intended to include savings from lower investment fees and operational/turnover costs as well as higher investment returns from smarter investment decisions within asset classes. We are not considering change in overall asset allocation, which we assume would not be substantially changed. A substantial change in asset allocation would clearly have wide implications.

Analysis for this appendix

In principle, there are two possible options for increasing scale within the eight Welsh LGPS funds:

- The eight funds could be merged into a smaller number of funds. For illustration, we have considered merger to form either three funds or a single LGPS fund across Wales. A single LGPS fund for Wales would have assets of approximately £12 billion.
- The eight funds could invest their assets collectively, which would probably be achieved using a CIV. In Appendix 5, we outline the mechanics of such a CIV if one were to be established specifically for Wales.

The CIV option does not exclude the possibility of merger, but there would be duplication of effort. Three funds could, for example, operate with a CIV.

If there were to be a single LGPS fund across Wales, there would be little long-term point in establishing a CIV for Wales. But if merger were difficult to achieve, a CIV might be a precursor.

The effect of reducing the number of unitary authorities can be considered separately from investment efficiency resulting from fund merger or CIV use. This is because merged funds can preserve notional segments for each unitary authority, as is already the practice.

The options are evaluated in Exhibit 13.

Exhibit 13

Number of Welsh funds	CIV participation	Net investment returns: potential for annual enhancement, based on assets of £11.8 billion	Timescale
8	None	Nil	Not applicable
8	England and Wales	£49 million for ultra-large CIV	Dependent on DCLG timing for England and Wales CIV
8	Wales only	£43 million for full take up of CIV	Two years
3	None	£14 million	Two to four years
3	England and Wales	£49 million for ultra-large CIV	Dependent on DCLG timing for England and Wales CIV
3	Wales only	£14 million (as result of merger) or up to £43 million for full take up of CIV	Two to four years
1	None	£43 million	Two to four years
1	England and Wales	£49 million for ultra-large CIV	Dependent on DCLG timing for England and Wales CIV

For this modelling, the key parameter is the impact on net investment performance as the quantum of assets under collective management is increased. We have taken a best estimate of the difference between net investment performance for small funds (classed for the purpose of this analysis as less than £1 billion) and large funds (classed as exceeding £10 billion) to be 0.5 per cent. We have then made incremental allowance for intermediate size as indicated in Exhibit 14.

Note that the estimated annual return enhancement is before an offset from transition costs (ie, costs associated with mergers or with establishing a Wales-only CIV). It is also before associated ongoing costs (eg, cost of running a CIV in Wales or joining an existing CIV in England and Wales).

These parameters are summarised in the final column of the below. For example, a fund of £5 billion to £10 billion is expected to achieve a net investment return of 0.2 per cent per annum lower on average than a 'large' fund given its lower scale. The table also shows the distribution of existing fund sizes of the Welsh funds. There are currently two funds in the £2 billion to £5 billion range, five in the £1 billion to £2 billion range and one fund below £1 billion. We have allowed for a modest 0.05 per cent as being achievable if 'ultra-large' CIV arrangements, spanning England and Wales, were to be established.

Exhibit 14

Fund asset range	Current number of Welsh funds	Size of assets under management within existing structures (£ billion)	Net of fee investment performance (impact as % of assets)
Greater than £25 billion ('ultra-large')			Max + 0.05%
£10 billion to £25 billion ('large')			Maximum
£5 billion to £10 billion	0		Max – 0.2%
£2 billion to £5 billion	2	4.3	Max – 0.3%
£1 billion to £2 billion	5	7.0	Max – 0.4%
Less than £1 billion ('small')	1	0.4	Max – 0.5%
Total	**8**	**11.8**	

Appendix 3

Estimated funding levels by council

This appendix contains the results of some detailed modelling looking at the possible effects on funding levels of the 22 unitary authorities should the number of authorities be reduced via mergers. It looks only at funding levels which drive deficit recovery contributions payable by LGPS employers. It does not present any illustrative impacts on contributions in respect of ongoing benefit accrual (known as the future service rate).

1. Illustrative scenario: funding levels pre unitary authority mergers (existing eight funds)

As a starting point, we consider a recent valuation position if there was no structural change, either to the number of funds (eight) or to the number of unitary authorities (22). The published funding levels of the LGPS fund (on differing actuarial funding bases) are shown in the third column of Exhibit 15, but funds do not publish funding levels for individual unitary authorities. However, it is possible to estimate the funding levels for each of the existing unitary authorities on a common standardised actuarial basis by manipulating data from their published IAS19 results in their 2013-14 accounts.

Estimates are shown in the fifth column of Exhibit 15, as at 31 March 2014, using a standardised basis with a discount rate of CPI plus three per cent. To be clear, this is not an IAS19 discount rate; the IAS19 results are used only to obtain data for each existing unitary authority. The discount rate used of CPI plus three per cent is used in other LGPS calculations, such as for cost cap purposes. The key point is not the rate itself, but the ability to make comparisons on a common basis and it is put forward solely for that reason. Other bases that provide a valid comparison could also have been used equally effectively with minimal difference in the relative positions described in this analysis.

The discount rate results in somewhat higher funding levels for several of the funds, but the important point at this stage of the analysis is to have comparability between funds.

The funding level estimates range from 65 per cent to 103 per cent.

Exhibit 15

		Funding bases		Common basis		
Fund actuary	**LGPS fund**	**2013 funding level (published)**	**Participating unitary authorities**	**2014 Pre unitary authority merger funding level (estimated) (%)**	**2014 Post unitary authority merger funding level (estimated) (%)**	**Impact on funding deficit (£m)**
Hymans Robertson	Gwynedd	85%	Gwynedd	99%	99%	1
			Conwy	103%	99%	12
			Isle of Anglesey	93%	99%	-12
Mercer	Clwyd	68%	Flintshire	72%	75%	-16
			Wrexham	80%	75%	20
			Denbighshire	74%	75%	-4
Aon Hewitt	Powys	79%	Powys	80%	80%	0
Mercer	Dyfed	89%	Carmarthenshire	94%	97%	-23
			Pembrokeshire	100%	97%	13
			Ceredigion	101%	97%	10
Mercer	Torfaen	71%	Torfaen	79%	79%	-1
			Newport	80%	79%	6
			Caerphilly	80%	79%	6
			Monmouthshire	77%	79%	-6
			Blaenau Gwent	78%	79%	-5
Aon Hewitt	RCT	78%	RCT	70%	71%	-9
			Bridgend	76%	71%	25
			Merthyr Tydfil	65%	71%	-16
Aon Hewitt	Swansea	81%	Swansea	82%	80%	20
			Neath Port Talbot	76%	80%	-20
Aon Hewitt	Cardiff	82%	Cardiff	82%	83%	-2
			Vale of Glamorgan	83%	83%	2

2. Illustrative scenario: funding levels after reduction to eight unitary authorities (existing eight funds)

Simply for illustration, we then consider eight funds remaining and 22 unitary authorities reduced in number to eight, in line with the funds they are now in.

The funding levels as at 31 March 2013, still using standardised assumptions, would then have been as shown in the last-but-one column in Exhibit 15 and now range from 71 per cent to 99 per cent. An averaging takes place between the former unitary authorities, so that the new, larger unitary authorities would have funding levels that were weighted averages of the former unitary authorities in each fund.

The notional gains or loss made by each of the former unitary authorities can then be estimated in terms of changes to the funding deficit corresponding to the employees and former employees of the former unitary authority. These are shown in the final column of Exhibit 15. Changes are generally modest, since there would be histories in common, but it is possible to identify the former unitary authorities making and taking the largest contributions:

- biggest gain: £23 million improvement to funding deficit: the former Carmarthenshire; and
- biggest loss: £25 million worsening of funding deficit: the former Bridgend.

3. Illustrative scenario: funding levels after reduction to nine unitary authorities (existing eight funds)

Under this scenario, all existing unitary authorities participating in each LGPS fund merge with each other, except that Bridgend (RCT Fund) merges with Vale of Glamorgan (Cardiff Fund) to become a unitary authority. The merged entity would then be one of two unitary authorities within one of the funds, for example the RCT Fund.

The updated results for this scenario are shown in Exhibit 16. For 17 of the former 22 unitary authorities, the results are unchanged from Exhibit 1.

Exhibit 16

Fund actuary	LGPS fund	Participating unitary authorities	Post merger unitary authority	Common basis		
				2014 Pre unitary authority merger funding level (%)	2014 Post unitary authority merger funding level (%)	Impact on deficit (£m)
Hymans Robertson	Gwynedd	Gwynedd	1	99%	99%	1
		Conwy		103%	99%	12
		Isle of Anglesey		93%	99%	-12
Mercer	Clwyd	Flintshire	2	72%	75%	-16
		Wrexham		80%	75%	20
		Denbighshire		74%	75%	-4
Aon Hewitt	Powys	Powys	3	80%	80%	0
Mercer	Dyfed	Carmarthenshire	4	94%	97%	-23
		Pembrokeshire		100%	97%	13
		Ceredigion		101%	97%	10
Mercer	Torfaen	Torfaen	5	79%	79%	-1
		Newport		80%	79%	6
		Caerphilly		80%	79%	6
		Monmouthshire		77%	79%	-6
		Blaenau Gwent		78%	79%	-5
Aon Hewitt	RCT	RCT	6	70%	69%	11
		Merthyr Tydfil		65%	69%	-11
		Bridgend	7	76%	79%	-15
		Vale of Glamorgan		83%	79%	15
Aon Hewitt	Swansea	City and Council of Swansea	8	82%	80%	20
		Neath Port Talbot		76%	80%	-20
Aon Hewitt	Cardiff	City and Council of Cardiff	9	82%	82%	0

For the remaining five former unitary authorities (Rhondda Cynon Taf, Merthyr Tydfil, Bridgend, Vale of Glamorgan and Cardiff), the results change to different degrees. The impact on Rhondda Cynon Taf and Merthyr Tydfil is now worse since they no longer benefit from the relatively higher funding level associated with Bridgend pre unitary authority merger. However, the impact on Bridgend is now dramatically better (a £15 million improvement compared to a £25 million worsening) because it benefits from the relatively higher funding level associated with Vale of Glamorgan pre unitary authority merger. An opposite effect is seen for the Vale of Glamorgan which moves from a modest worsening of £2 million to a larger worsening of £15 million.

Overall, the biggest impacts would be:

- biggest gain: £23 million improvement to funding deficit: the former Carmarthenshire (as previously); and
- biggest loss: £20 million worsening of funding deficit: each of the former Wrexham, Swansea and Neath Port Talbot (replacing Bridgend).

4. Illustrative scenario: funding levels after reduction to 12 unitary authorities (existing eight funds)

Under this scenario, three unitary authorities continue (Carmarthenshire, Powys and Swansea). Sixteen of the unitary authorities merge with one other unitary authority to become a new unitary authority and finally three unitary authorities merge with two other unitary authorities to become a new unitary authority.

The updated results for this scenario are shown in Exhibit 17. Not surprisingly, there is no impact on the deficit position for Carmarthenshire, Powys and Swansea. In contrast, Carmarthenshire was previously noted to benefit from a merger with unitary authorities with better funding levels. There is also now no impact on the former Bridgend and the former Neath Port Talbot because they have the same pre unitary authority merger funding level (measured on a common basis) and therefore this will continue post unitary authority merger.

Exhibit 17

Fund actuary	LGPS fund	Participating unitary authorities	Post merger unitary authority	Common basis		
				2014 Pre unitary authority merger funding level (%)	2014 Post unitary authority merger funding level (%)	Impact on deficit (£m)
Hymans Robertson	Gwynedd	Gwynedd	1	99%	97%	9
		Isle of Anglesey		93%	97%	-9
		Conwy	2	103%	88%	50
	(Clwyd)*	Denbighshire		74%	88%	-50
Mercer	Clwyd	Flintshire	3	72%	76%	-18
		Wrexham		80%	76%	18
Aon Hewitt	Powys	Powys	4	80%	80%	0
Mercer	Dyfed	Carmarthenshire	5	94%	94%	0
		Pembrokeshire	6	100%	100%	-1
		Ceredigion		101%	100%	1
Mercer	Torfaen	Torfaen	7	79%	79%	-1
		Caerphilly		80%	79%	6
		Blaenau Gwent		78%	79%	-5
		Newport	8	80%	79%	6
		Monmouthshire		77%	79%	-6
Aon Hewitt	RCT	RCT	9	70%	69%	11
		Merthyr Tydfil		65%	69%	-11
		Bridgend	10	76%	76%	0
	(Swansea)*	Neath Port Talbot		76%	76%	0
Aon Hewitt	Swansea	Swansea	11	82%	82%	0
Aon Hewitt	Cardiff	Cardiff	12	82%	83%	-2
		Vale of Glamorgan		83%	83%	2

* Indicates former fund before change of fund arising from unitary authority merger.

Overall, the biggest positive and negative impacts are different from the previous scenarios and their impacts are much greater (twice the size). Note that they arise under this scenario purely because two unitary authorities with very different LGPS funding levels (on common basis) are earmarked for merger:

- biggest gain: £50 million improvement to funding deficit: the former Denbighshire; and
- biggest loss: £50 million worsening of funding deficit: the former Conwy.

Although these largest impacts are much greater than for the previous Exhibit 16, there are fewer significant impacts across the former unitary authorities as a whole. For example, for a reduction to 12 unitary authorities (Exhibit 3), the impacts are £15 million or more in four cases, whereas for a reduction to nine unitary authorities (Exhibit 3), the impacts are £15 million or more in seven cases.

5. Illustrative scenario: number of funds were reduced to three (north, west and mid, and south) and reduction to nine or 12 unitary authorities

There would be no further impact on deficit results measured on a common basis for each of the new larger unitary authorities. This is because the three funds would each have several (between two and four) of the new unitary authorities.

6. Illustrative scenario: number of funds were reduced to one and reduction to nine or 12 unitary authorities

There would be no further impact on deficit results measured on a common basis for each of the new larger unitary authorities. The single fund would have notionally segmented assets, liabilities and funding levels for each of the new unitary authorities.

7. Comment on results under actual rather than standardised/common actuarial bases

Considerations will include:

- lower funding levels, if more prudent assumptions, essentially moving back towards the published funding levels for funds in 2013;
- development in funding levels between 2013 and 2016; and
- appointments of actuaries if fund numbers reduce from eight, to three or one.

Appendix 4

Data on current administration and investment costs

Exhibit 18

Region	Fund	Total assets (£m)	Total members	Total admin and other costs (£m)	Total investment management cost (£m)	Total cost (£m)	Average admin cost per member (£)	Investment cost (% of asset values)
North	Gwynedd	1,310	32,274	1.3	6.9	8.1	39	0.5%
	Clwyd	1,215	34,675	1.0	6.4	7.4	28	0.5%
Middle	Powys	445	15,934	0.9	2.2	3.1	58	0.5%
	Dyfed	1,667	42,573	0.9	2.1	3.0	22	0.1%
	Swansea	1,376	36,072	1.0	11.6	12.6	28	0.8%
South	Torfaen	2,073	51,256	2.0	5.6	7.6	40	0.3%
	Rhondda Cynon Taf	2,237	64,870	1.7	5.9	7.7	27	0.3%
	Cardiff	1,466	34,722	1.0	4.1	5.0	27	0.3%
Total		**11,789**	**312,376**	**10**	**45**	**55**		

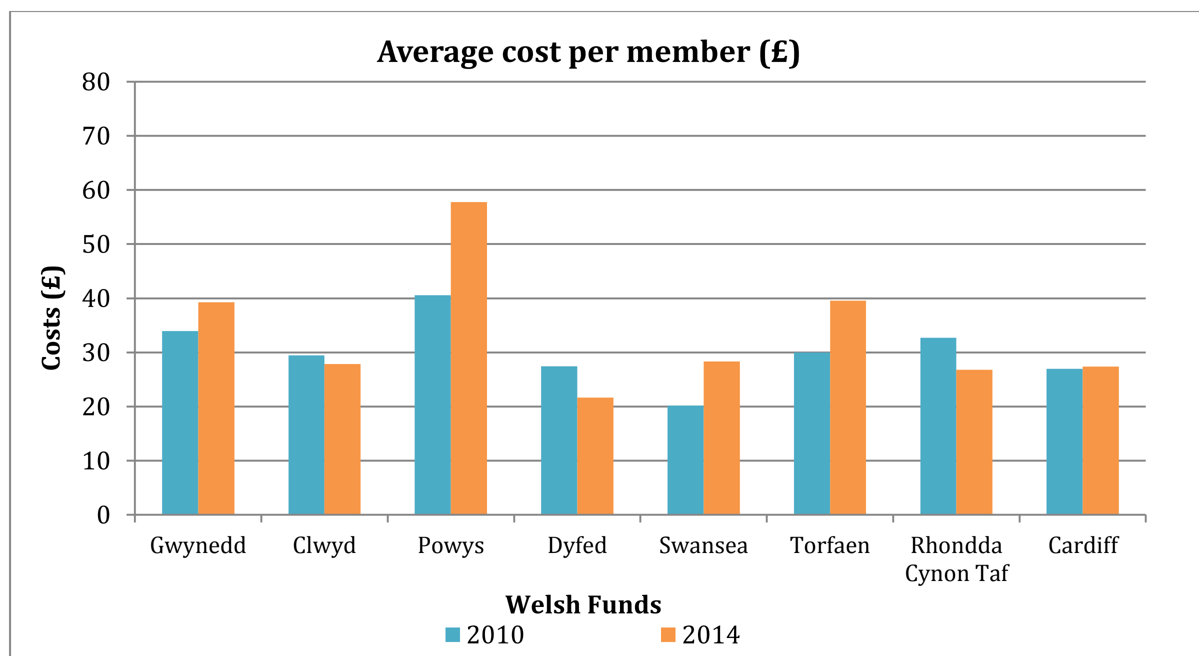
Source: SF3 data published by DCLG for 2013-14

Administration and other (non-investment) cost data

The total cost across eight funds for 2013-14 was £10 million.

The data is shown graphically below, with comparisons back to SF3 data for 2009-10. The smallest fund, Powys, continues to have the highest per member administration costs with the differential from other funds increasing between 2010 and 2014. For three funds, the average cost per member has reduced over the period. However, the scope of the administration service provided by different LGPS funds varies, and within individual funds the scope of service may also change over time.

Exhibit 19



Meaningful comparisons of administration costs between funds, and within funds over time, are inevitably difficult.

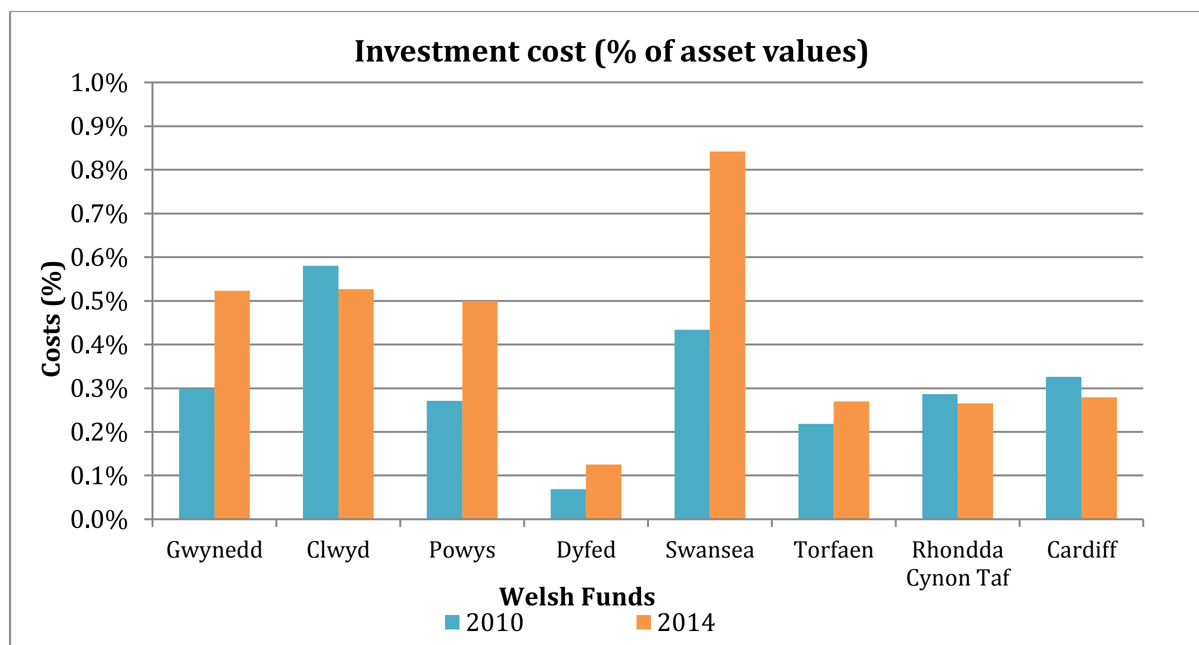
The scope of the administration service provided by different LGPS funds varies, and within individual funds, the scope of service may also change over time.

DCLG's own analysis of the SF3 data for England and Wales for 2013-14 does show a broad relationship between fund size (both in terms of assets under management and number of members) and administration costs per member. Generally, the larger the fund, the lower the administration cost per member, and this is borne out in Wales data.

Investment cost data

The total investment fees charged to the funds across the eight funds for 2013-14 was £45 million. This is 4.5 times greater than costs on administration and other non-investment related costs.

Exhibit 20



Source: SF3 data published by DCLG for 2009-10 and 2013-14

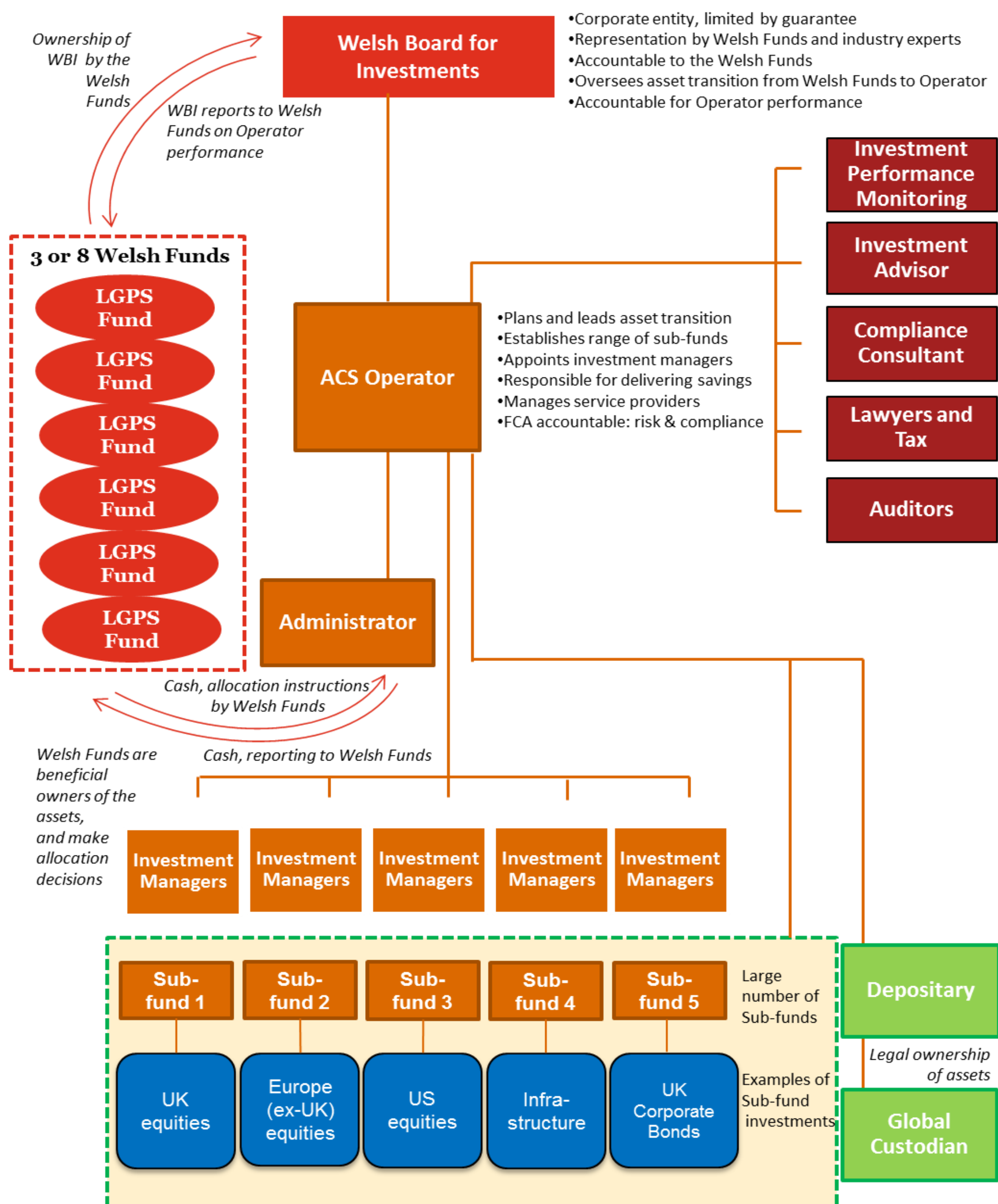
As the chart above shows, investment costs vary greatly between funds in Wales, and over time. There are many factors which affect investment costs and make meaningful comparison difficult, such as:

- Asset allocation – different asset classes have different investment costs.
- Investment management style – passive management (as used extensively by Dyfed) is lower cost than active management.
- Performance-related fee structures – each one will be structured differently, and as the amount payable is variable each year, they can cause large fluctuations in investment costs year on year. For example, a large proportion of the investment costs for the Swansea Fund in 2013-14 are due to a large performance-related fee being payable during the year, but which related also to cumulative performance from prior years.
- Changes to investment strategy or investment managers – transition costs can be significant when implementing a change to the investment strategy or transitioning from one investment manager to another.

Appendix 5

A possible collective investment vehicle for Wales

Exhibit 21



Potential CIV structure: the ACS

Exhibit 21 illustrates one possible model for the pooling of certain assets of the Welsh LGPS funds into a central CIV or CIVs. It uses an ACS. The ACS is a tax-effective structure introduced into the UK funds landscape in 2013. The participating LGPS funds would hold units in the ACS under co-ownership and the model permits the operation of a number of sub-funds under the one vehicle resulting in greater efficiency in terms of both establishment and ongoing costs than other alternatives.

ACSs are not themselves subject to UK corporation tax, income tax or capital gains tax and are tax transparent for income. Pension funds typically favour tax-transparent vehicles so that they do not suffer 'tax drag' on their overseas investment returns. Management services supplied to an ACS should be exempt from VAT under the management of 'special investment funds' exemption.

An ACS and its operator would require authorisation by the FCA and would be subject to its ongoing supervision. Each sub-fund of the ACS may have its own investment objectives and different investment managers may be appointed for each, thereby allowing the ACS to benefit from the full range of cost efficiency, expertise and market performance available in the market.

Operator models

The ACS structure for a CIV requires there to be an operator, to be authorised by the FCA. Day-to-day interactions involving cash flows and asset allocation instructions would be through the Administrator appointed by the operator. The investment performance of each LGPS fund would depend on its choice of asset allocation, with reliance on the operator to deliver effective performance from each sub-fund.

There are two main delivery models for an operator: build or rent:

- Building an operator would create a Welsh LGPS funds/Welsh Government asset. It could be located locally, and could generate some internal management efficiencies on asset management. Establishment and authorisation would take longer, and have significant costs. Risks would have to be managed. 'Build' is the option that London CIVs have chosen to implement.
- Renting an operator is the faster and lower initial cost route to setting up a CIV. Procurement processes under OJEU would be required. Interest from a number of possible providers might be expected. It is likely to be the lower-risk route, particularly if levels of take up are modest. 'Rent' is the option that the SWT is currently understood to be considering.

Delivery models involving private sector partners have lower initial set-up costs for government.

However, these costs would ultimately be passed back to government as operating costs over the life of commercial agreements.

Governance

A practical way to separate the operational and oversight functions would be needed. The operator would be responsible for delivering the envisaged savings. Its key functions may be to establish investment sub-funds, and to appoint, manage and dismiss investment managers to operate them. Oversight could then be by a separate body, an Investment Board which would be accountable to the Welsh LGPS funds and to the Welsh Government for the performance of the operator. The primary benefits of the separation of the operator and oversight functions are:

- As it would not require FCA regulation, the Investment Board could bring a range of perspectives to the oversight role. The Welsh LGPS funds would be fully represented, channelling their voices through the board.
- The board viewpoint could be wide, including economic and infrastructure issues.
- The operator could focus solely on meeting investment challenges, to deliver investment savings and performance, at scale, in each asset class that it offered.

The Board could be the forum for aggregation of portfolio information and analysis, enabling a single consolidated view of performance.

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