Recent developments in the Local Government Pension Scheme (LGPS)

Introduction

The Local Government Pension Scheme (LGPS) has 5 million members (active, deferred and pensioner) making it one of the largest open DB schemes in England and Wales. Employers in the scheme include local authorities and public service organisations as well as other employers which provide the LGPS for their employees by becoming admitted bodies.

The LGPS provides salary-related, Defined Benefits (DB), where the individual's pension entitlement is not dependent upon investment performance. The scheme is administered for participating employers locally through 89 funds in England and Wales. The scheme has assets of around £192.1bn,[1] as a funded scheme, it is different to other public sector schemes which are unfunded.

The LGPS is under continued pressure to deal with scheme deficits (£47bn)[2] by improving investment returns and reducing administration costs, and more recently pressure to invest more in infrastructure in the UK.

This briefing note covers some of the history of LGPS including previous Government reforms. It discusses the current proposed changes (including the pooling of funds and increased investment in infrastructure in the UK) across four elements (scale, costs, governance and infrastructure) along with possible partnership arrangements. It seeks to outline further questions to be considered as the LGPS changes are implemented.

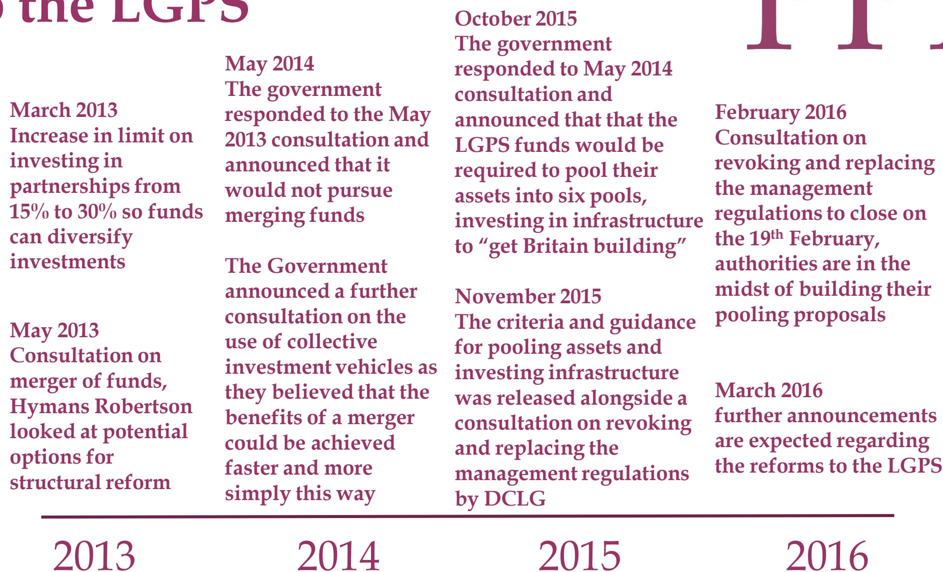
History of the LGPS

In the late 1980's the government reduced target funding levels for pension schemes. Many DB schemes, including the LGPS were in surplus at the time and reduced or ceased paying contributions for a number of years. Although considered an appropriate response at the time, the short term benefits were outweighed by the subsequent poor market performance and many schemes are still in deficit today.

There are other elements in addition to the contribution reduction and holidays such as longevity and investment returns, that have contributed to building up the deficit.

In March 2011, Lord Hutton of Furness' Independent Public Service Pensions Commission report suggested incentivising the merger of funds.[3] Following this there has been a number of consultations considering structural reform for the LGPS. Chart 1 looks at the timeline of on-going reforms to the LGPS. Recent focus has been on sustainability and cost effectiveness, while improving the rate of return.

Chart 1: Timeline of reforms to the LGPS



Source: House of commons library (2015), *Local Government Pension Scheme Investments*

PPI Briefing Notes clarify topical issues in pensions policy.

On 25 November 2015, the criteria and guidance for pooling assets and investing infrastructure was released by the Department for Communities and Local Government (DCLG)

Administering authorities have to respond to the Government with their proposals by 19 February 2016. Amongst the detailed criteria (Chart 2) it states that the 89 administering authorities in England and Wales must collaborate to create 6 pools that are at least £25bn in size. The Government considers that this is a sufficient number so that it removes duplicate activities as well as reduces management costs.[4]

Criteria were published alongside a DCLG consultation about revoking and replacing the LGPS management and investment of funds regulations.[5] The consultation included two main changes to the regulations:

1. The removal of prescribed means of securing a diversified investment strategy and placing decisions about investments with authorities.
2. Introducing safeguards to ensure that the more flexible legislation in the criteria and the guidance on pooling of assets is adhered to correctly.

In addition, the consultation introduced backstop legislation. This suggested that powers were given to the Secretary of State to intervene in the investment function of an administering authority if needed.

The four key areas of reform

Overall, the reforms to the LGPS focus on four main areas:

i. Scale;
ii. Reducing cost;
iii. Improving governance; and
iv. Investing in infrastructure.

i. Scale

Building economies of scale generates the opportunity for the funds to reduce operational costs and invest in infrastructure. Consolidation of 89 funds into 6 pools means that each pool represents 'one client'. This could lead to the reduction in the number of investment managers required.

There are various advantages of pooling assets. For example, larger investors have greater leverage over charges and typically more access to invest in alternative assets, such as infrastructure.

Chart 2: Pooling Criteria

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Asset pools must achieve benefits of scale
- The size of the pool once fully operational
- Rationale for maintaining assets outside of the pool
- The type and legal structure of the collaborative vehicle
- How the pool will operate
- Timetable for establishing the pool

Strong governance and decision making
- Maintenance of appropriate management and oversight at local level
- Adequate risk management and assessment at pool level
- Governance structure of the pool – including accountability of local/pool level

Reduced costs and excellent value for money
- Active management must be shown to deliver value for money on a risk-adjusted, long-term basis
- A full transparent assessment of investment costs and fees as at March 31 2013
- A detailed forecast estimate of savings over the next 15 years

An improved capacity to invest in infrastructure
- Current allocation to infrastructure
- Planned allocation to infrastructure
- Plans for developing capacity and capability to assess infrastructure projects

Source: DCLG (2015), *Local Government Pensions Scheme: Investment Reform Criteria and Guidance*

Although the increase in size may unlock access to certain investments and be beneficial in achieving cost savings it also comes with risks. For example, there can be size restrictions on certain investments or funds. Similarly larger funds can be too big to fulfil their target allocation (the amount that the LGPS aims to allocate to each asset) within a preferred manager or direct investment opportunity. Other risks include difficulty in switching in and out of the large position and possible delays in

execution of investment decisions.[6]

'Big' is also a subjective term. Within pension funds a big fund in one country may be considered small in another.[7] It is difficult to know whether the £25bn that the Government has suggested is the right size to unlock all the benefits.

ii. Reducing cost

The reduction of operational costs is expected through building economies of scale and moving from active to passive management of assets. The report suggested that a move from active to passive management for equities and bonds could save between £200m to £260m.[8] The modelling uses a set of assumptions which are based on a subset of the funds (18). As with all models, it is based on specific assumptions and a sample rather than a complete dataset, so there remains a degree of uncertainty around these estimates. Although the report recognises that some actively managed funds had performed well, it found that across the sample, in aggregate, equity performance before fees had been no better than the index. The estimated savings therefore assume that there is no benefit in terms of higher returns from active management.

Current criteria requires funds to show that active management delivers value for money on a risk adjusted long term basis (Chart 2). Authorities have been asked to report on how fees and the net performance for each active asset class compares to a passive index. The Government has recognised that all decisions that are made by Local Authorities are with a long-term view adopting a 'culture of continuous improvement'. However, it may also be useful to consider how much of the cost savings will deal with the problems that have contributed to the position that the scheme is in now.

Although cost savings are predicted to be between £200m and £260m, this amount is relatively low compared to the deficit that the scheme has built up (£47bn).

The root causes of the deficit may not be directly addressed within these reforms as there are other elements (such as contribution holidays, longevity, investment returns) that have contributed to building up the deficit.

iii. Governance

The Government expects that the pooling of assets will induce strong governance, increase transparency and improve the decision making of the LGPS.

Authorities are in the process of designing their governance structures for their pools which includes the accountability between the pools and the structure for the internal management that is expected to take place. However, there are practical and operational considerations that arise from allowing governance to be structured this way, the Government has recognised this and have issued a consultation on revoking and replacing the management regulations which introduces powers to the Secretary of State to intervene if the criteria is not adhered to correctly.[9]

iv. Infrastructure

The final focus of the reforms is around increased investment into infrastructure in the UK.

Infrastructure assets include physical investments such as: toll roads, railways, seaports, airports, power stations, electricity pipelines and power stations. There are many advantages of investing in infrastructure such as promoting economic growth, diversifying the investment portfolio and the potential of producing long-term returns. However, there can also be many disadvantages such as construction risks, high investment costs and lower returns.[10]

There has been little investment by the LGPS into infrastructure in recent years as they have generally utilised alternative forms of illiquid investments to achieve their strategic asset allocation. Chart 3 shows the lack of investment generally by the LGPS into this asset class. Within the 'other' asset class (5.7%) infrastructure investment stands at 6%, reported in the scheme annual report 2014.[11]

National Infrastructure Commission

In response to a perceived lack of expertise to invest in infrastructure, the Government has set up an independent National

Infrastructure Commission as a platform to encourage investment into this area and to oversee the long-term strategic decision making with regards to infrastructure in the UK.[12]

Experience from overseas; Canada and Australia

In Canada and Australia, consolidation of pension funds has been a prominent trend, alongside investment into infrastructure and internal management.[13] Chart 4 looks at the emerging trends from these countries, the key trends include fund consolidation specifically in Australia where funds are projected to decline from 447 to 74 by 2035. Another key trend is that both countries have been acknowledged as top investors into infrastructure with the highest asset allocation of around 5% compared to the global average of 1%.

Chart 3: Total assets of LGPS @ March 2014

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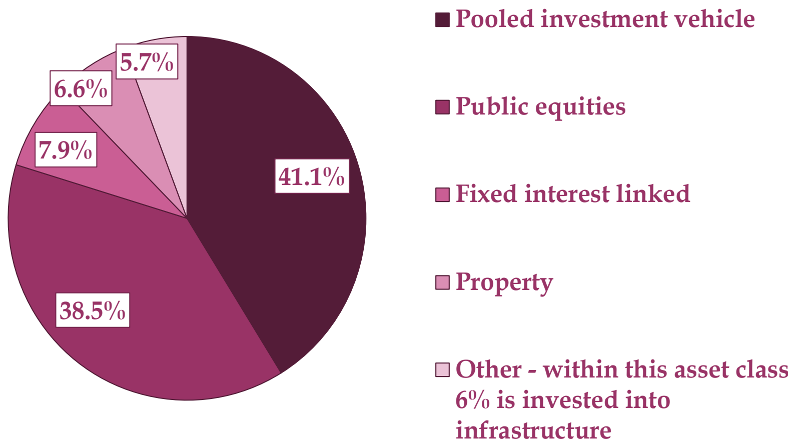
This chart shows where the assets of the LGPS were placed in 2014



Source: LGPS (2014), *Scheme annual report*

Chart 4: Global Comparisons of pension funds

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Australia

- The trend of consolidation is prominent in Australia where superannuation funds are projected to decline from 447 to 74 by 2035 due to the consolidation of funds.
- Operational costs of pensions are said to be 40% lower than the UK as in-house investment management is increasing.
- Australian pension funds have been increasing investment in infrastructure since 1990's. Australia alongside Canada has the highest asset allocation dedicated to infrastructure which is around 5%, compared to the global average of 1%.

Canada

- There is an increasing trend in Canada towards in-house investment management specifically in larger plans and investments in infrastructure which is also increasing such as the UK's High Speed One rail line.
- There is a decline in DB schemes and an increase in pooled registered pension plans (PPRP) a scheme designed for those who do not have a workplace pension. Members benefit from low admin costs due to the pooling of assets.
- Canadian pension assets grew 6.8 per cent between 2007 and 2012 and outperformed UK and Dutch assets, which grew 0.4 per cent and 1.8 per cent respectively.

Source: OECD (2013), *Pension Fund Investment in Infrastructure: A comparison between Australia and Canada*

The DCLG criteria states that there will be increased investment into the infrastructure asset class by the pools. There is a potential trade-off that arises from this regarding state social responsibility and how it fits with the fiduciary duty to scheme members. Although investment into infrastructure is beneficial for the economy, it may not be beneficial for each individual LGPS member. Forcing investment into infrastructure will restrict the pool members investment choice and may not be suitable or desired by each individual, this in turn interacts with the fiduciary duty to scheme members.

Infrastructure projects pose a variety of risks, such as time scale, construction risks, phase of investment (build vs. operational) and rate of returns making it a non-homogenous asset

class. Investment in individual infrastructure projects would need to be matched with specific fund objectives.

Possible pooling arrangements

In terms of how funds will be brought together, there are a number of possibilities. Specifically:

- **Those with a like-minded approach**

Schemes with a like-minded approach are likely to form partnerships. For example, London and Lancashire who signed a partnership agreement in July 2015.[14]

The Government has encouraged other schemes to use London and Lancashire as an example to follow, as they have already been developing a pool and reducing costs. This partnership was formed on the basis that both are like-minded schemes which have a similar market outlook. However, London and Lancashire will still need to expand their collective if they are to exceed the £25bn figure.

Schemes such as London and Lancashire can benefit from partnerships by sharing their expertise and knowledge while maintaining equal control over the pool.

- **Internal investment management expertise**

The Government encourage in-house investment management to deliver the cost savings set out in the reforms. The pooling arrangement could have significant effect on the management of pooled investments. It will be beneficial for experts from each authority to share their knowledge and expertise on all different asset classes however, the decisions made may be unbalanced with fewer representatives from the smaller schemes.

There are also other possible structures, such as **regional**, which some appear to be considering (for example the South West) and 'one large, many small'. In this instance, not all the schemes are of a similar size. Arrangements to manage these relationships may be more complex as decisions will be required over the weighting of control over the pool.

Once the six funds are set up, it is unclear what choice or flexibility to move to another pool the funds will have. It is also unclear as to what impact this might have on member outcomes in the long-term.

Chart 5: Main questions arising from the reforms

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- How much will the cost savings deal with the wider issues of the LGPS?
- What is the right size for each pool?
- What happens if the funds do not share the same outlook?
- What is the balance between active and passive investment management so as to deliver value for money for members?
- How will state social responsibility interact with the fiduciary duty of the scheme?
- What is the potential impact of little or no flexibility for funds to move to another pool once the system is fully operational?

Conclusion

This briefing note summarises the reforms to the LGPS and highlights the key areas within the criteria scale, cost, governance and infrastructure. As the implementation of the changes happen, there are questions that still remain unanswered (Chart 5). These questions need to be carefully considered to ensure scheme members do not lose out overall from any decisions made.

The next steps taken by the local authorities will be to prepare their pooling proposals and look to secure their partnerships and begin structural transition into 6 pools. It is likely there will be further announcements in the March 2016 Budget where the Government will respond to the consultation on revoking and replacing the management regulations.

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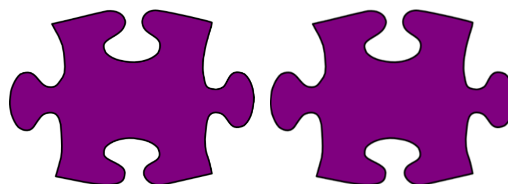

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