LGPS performance analysis

Introduction
UNISON commissioned APG (All Pensions Group) to analyse a dataset containing data on 101 LGPS (Local Government Pension Scheme) funds.

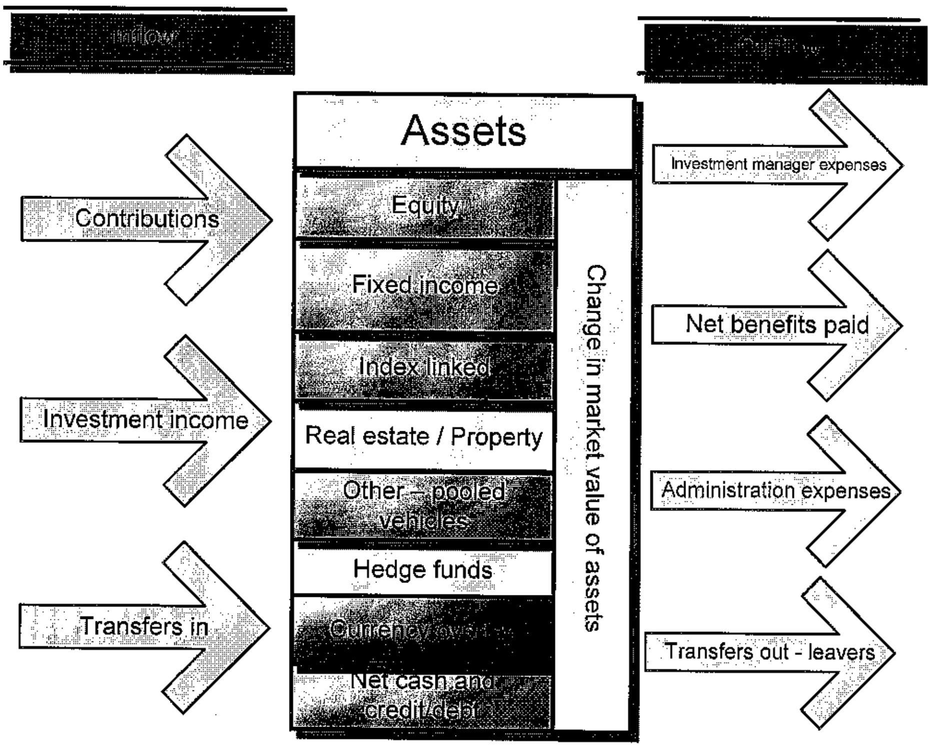
The main goals were to find out how good the investment performance of the LGPS funds was over a period of several years, whether they had outperformed against a benchmark and if consolidation could lead economies of scale to be unlocked.

The importance of the research is amplified by the inclusion of the results in the report by the Public Sector Pension Commission chaired by John Hutton.

Data
The data used originates from *Pension Funds Performance Guide – Local Authority Edition 2010*. The dataset contains data on 101 LGPS funds over the period 2001 to 2009. Some of this data was manually updated and corrected by UNISON, due to inconsistencies in the reporting standards applied by the LGPS funds.

The data received contained data on:
- End-of-year asset values and cash flows within the years (depicted by the arrows in figure 1)
- End-of-year asset values of the different asset classes (depicted by the coloured rectangles)
- Change in market value of the assets
- Figures on the population underlying the fund: active members, deferred members and retirees

Figure 1. Overview of dataset



These preliminary results show that more pension money will be left for the LGPS members if the institutional set-up of the LGPS is changed. Dividing the sum of the additional return on assets (£9.6 billion) and the additional assets due to lower expenses (£793 million) by the total number of members of the LGPS funds, we find that each LGPS member gains £275 a year for the period 2001-2009 if the LGPS funds are merged to form 14 regional funds.

Executive summary

UNISON asked APG to evaluate the investment performance of the Local Government Pension Funds over the period 2001 to 2009. The Local Government Pension Scheme (LGPS) is administered by 101 separate funds in England, Northern Ireland, Scotland and Wales. This unique structure allows for comparisons between the different funds and examination of the merits of merging funds to exploit economies of scale.

On average, the LGPS funds achieved a good investment performance. Over the period 2001-2009, the funds realised an investment return of 1.7% p.a., which is 1.0 percentage points higher than the benchmark return.

The high volatility in investment return over the period 2001-2009 is remarkable, and can be attributed to the high exposure to equities. Investment returns ranged from -19.7% during the dot com crisis to +24.7% in the post-crisis boom and back to -20.7% during the credit crisis. And although not all year-end market valuations for March 2010 had been reported at the time of this study, total asset values of the LGPS funds are likely to have risen from £121 billion to £160 billion, an increase of 33%.

Even though the LGPS has a good investment record on average, large differences exist between the funds. The difference in investment return between the best and worst performing funds is 10 percentage points in normal years and 20 percentage points during the dot com and credit crises.

Given these differences between funds, our research shows that substantial improvement in investment performance could be realised by increasing the size of funds. We found the following effects:

- Investment expenses and administration costs as a percentage of assets decline when the size of the fund increases. Investment expenses decrease by up to 0.3 percentage points of assets, and administration costs by up to 0.15 percentage points of assets when a fund of £1 billion merges to a fund size of £8 billion.
- Larger funds consistently achieved higher investment returns over the period 2001-2009. The four largest funds outperformed the benchmark on average by 2.2 percentage points p.a., ranging from 1.2 to 2.8 percentage points.
- Simulations of a regional consolidation scenario for the period 2001-2009 show that, applying the outperformance by the four largest funds, the other funds could collectively have reported an extra £9.6 billion in assets in 2009.
- Similarly, reductions in investment expenses in line with the increase in assets due to consolidation could in total have led to an extra £793 million over the period 2001-2009.

The above results may be improved upon by using more detailed data on the LGPS funds. Return data on individual asset classes may, for example, show why larger funds outperform smaller ones.

Performance analysis of LGPS funds

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Descriptive statistics

Important note: all years in this report are accounting years instead of calendar years. For example, 2009 corresponds to the period April 2008 to March 2009.

In total, 101 funds were included in the research, spread across four countries: England, Northern Ireland, Scotland and Wales. England accounts for the largest share of the total assets, while Northern Ireland has the lowest. Unlike the other countries, Northern Ireland has just one fund to service its members. In contrast, the London area is divided into 33 LGPS funds.

Table 1. Descriptive statistics LGPS funds, accounting year 2009 (£ million)

	UK	England	Northern Ireland	Scotland	Wales
No. of funds	101	80	1	12	8
Assets	121,120	96,777	2,474	15,708	6,160
Contributions	9,040	7,348	164	991	538
Benefits	6,893	5,675	122	713	383
Investment expenses	325	249	6.5	49	20
Administration expenses	134	111	2.3	12	8.2
Investment income	3,266	2,765	48.5	477.3	-24.8*
Members (in x 1,000)	4,729	3,930	87	451	262
Average per fund					
Assets	1,199	1,210	2,474	1,309	770
Investment expenses	3.2	3.1	6.5	4.1	2.5
Administration expenses	1.3	1.4	2.3	1.0	1.0
Investment income	32.3	34.6	48.5	39.8	-3.1*
Members (in x 1,000)	47	49	87	38	33

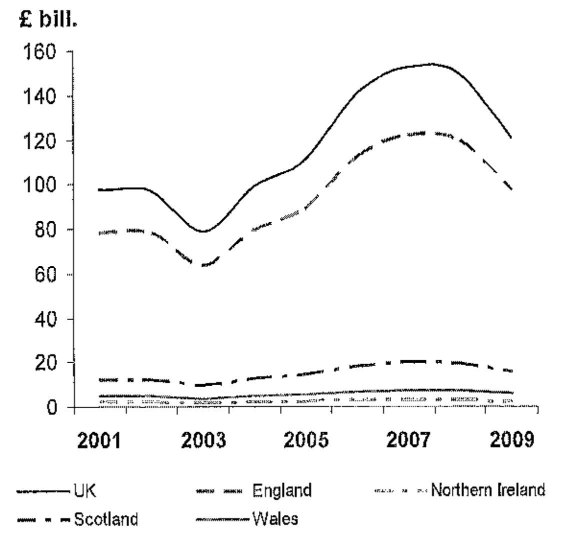
*The investment income in 2009 in Wales is not representative of the average investment income during the period 2001-2009. For the period 2001-2008, the average investment income of funds located in Wales was £133 million.

All 101 funds are responsible for one scheme. This means that each fund has its own Pension Committee that is responsible for the asset management and administration operation. This structure makes the 101 funds uniquely positioned to merge their activities. Consolidation of pension funds usually includes the difficult process of harmonizing different pension schemes. The LGPS funds can avoid this process and "only" have to merge their governance and administrative processes.

Looking at the period from 2001 to 2009, we observe a few trends:

- The asset volume was volatile;
- Contributions grew faster than the benefits paid;
- Administration costs have been constant;
- Investment expenses doubled between 2001 and 2009;
- The portion of risky assets in the asset mix has remained fairly stable.

Graph 1. Asset volume is volatile



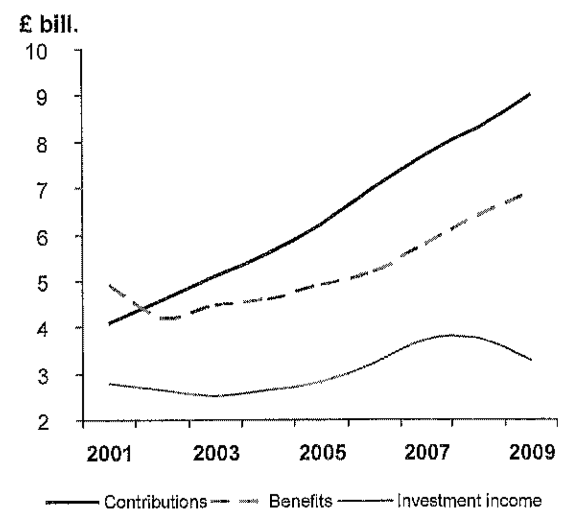
The fund's asset volumes were highly volatile over the period 2001 to 2009.

The English funds in particular clearly show the effects of the financial crises in 2003 and 2008 & 2009. The impact of the crises is delayed due to the use of accounting years instead of calendar years. Over the entire period, the asset volume grew by slightly more than 20%.

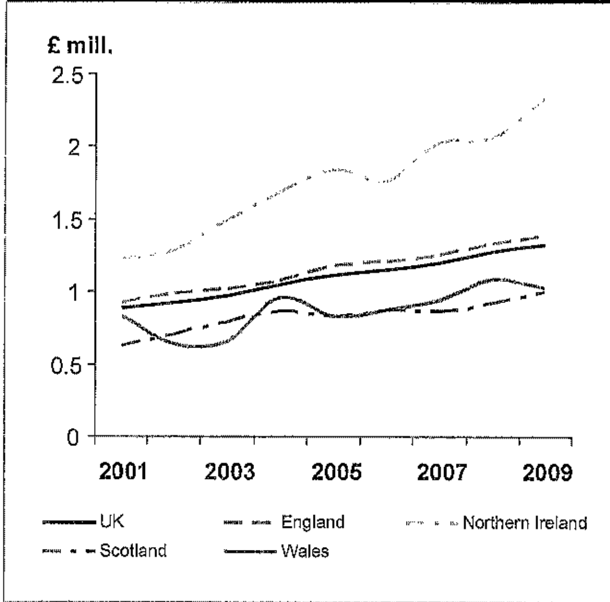
Both contributions and benefits increased sharply. While the absolute amount of contributions was lower than benefits paid out in 2001, this quickly changed due to the steep increase in contributions.

Over the 2001-2009 period, benefits rose by 40% while contributions increased by 120%. Including other cash flows, the LGPS funds are cash-positive on average.

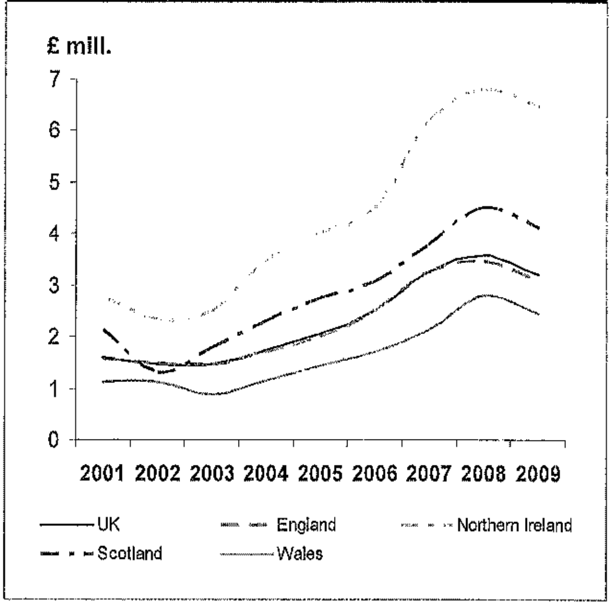
Graph 2. Total contributions, benefits and investment income



Graph 3. Constant real administration costs



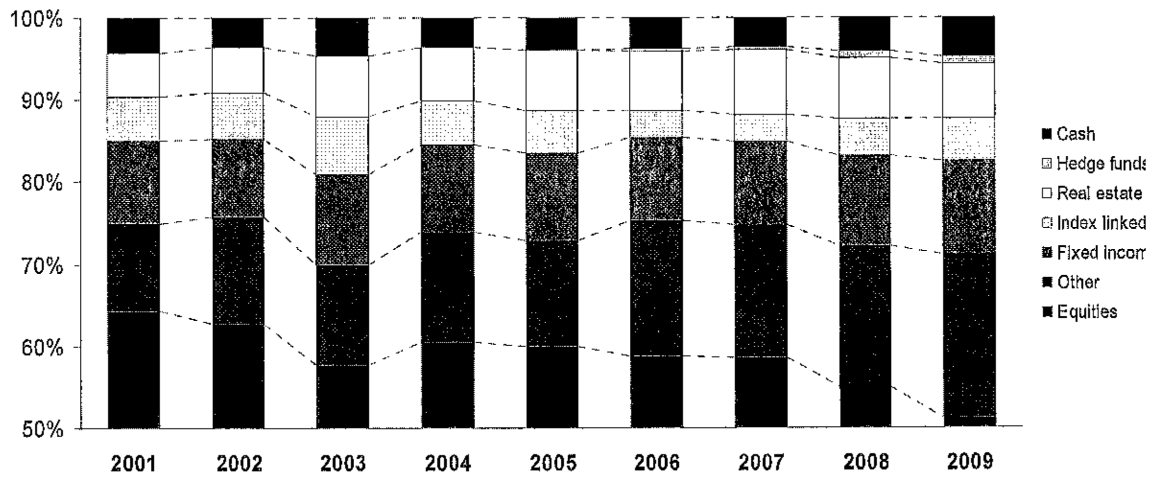
Graph 4. Investment expenses doubled



Looking at the reported costs of the LGPS funds, the average administration costs increased in line with inflation, meaning they have been stable in real terms over the period.

The average investment management expenses are less stable; these have doubled since 2001 as a percentage of total assets and in average absolute terms (the latter can be seen in graph 4).

Graph 5. Stable asset mix



The asset mix was relatively stable over the period 2001-2009. There was a substantial decline in equities (-13 percentage points) while the 'other' category increased (+9 percentage points). The exact content of 'other' is unclear. It is reported to include mutual funds and other pooled vehicles. A qualitative check on multiple annual reports of various funds showed that it consists mainly of equity-like assets. Therefore, the shift in the asset mix could be interpreted as a move away from equities or a shift from individual stocks towards mutual funds.

The other asset classes were relatively stable, with real estate, fixed income and hedge funds increasing slightly. Hedge funds appeared in the asset mix from 2006 onwards.

Evaluating the investment return

To evaluate the return of the LGPS funds we had to deduce a return from the annual report statements. We were able to compare this return with a benchmark return to get an impression of how well the LGPS funds manage their assets.

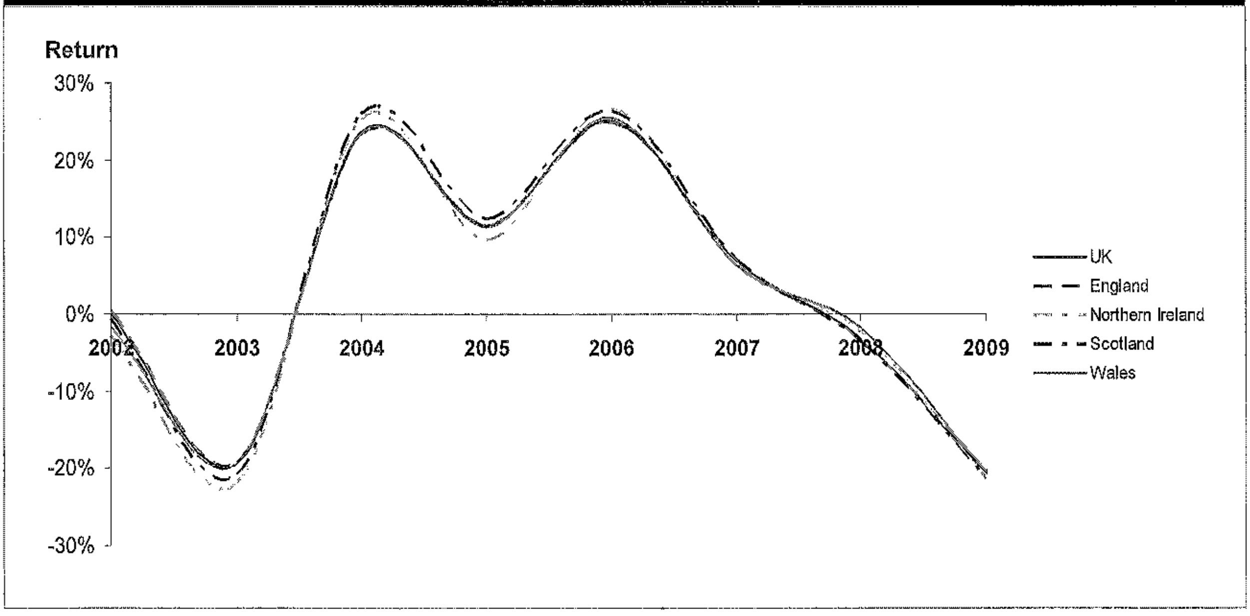
Due to a lack of data on the returns of individual asset classes, we had to find another way to obtain a return figure. Our approach was to look at it from a client perspective, the client being the members – what did they put in and what did they receive, with the difference being the return obtained by the pension fund. We call this return the *financial return.*

The financial return is defined as the ratio of stated fund value at year-end in year *t+1* over stated fund value in year *t*. However, this overlooks the fact that the members produced cash flows that cannot be used in the return calculation. For example, while an increase in contributions in year *t* raises the volume of assets in year *t+1*, it does not count as a financial return. Some cash flows are therefore subtracted before the financial return is calculated. These cash flows are the contributions, benefits paid out and transfers in and out. Consequently, the financial return consists of the investment income, administration expenses, investment management expenses and change in the market value of assets.

$$\text{Return} = \frac{(\text{Stated fund value at year's end}_{t+1} - \text{cash flows}_{t+1})}{\text{Stated fund value at year-end}_{t}} - 100\%$$

This return was calculated for each fund in the period from 2002 to 2009. The results for each country as a whole are shown in graph 6.

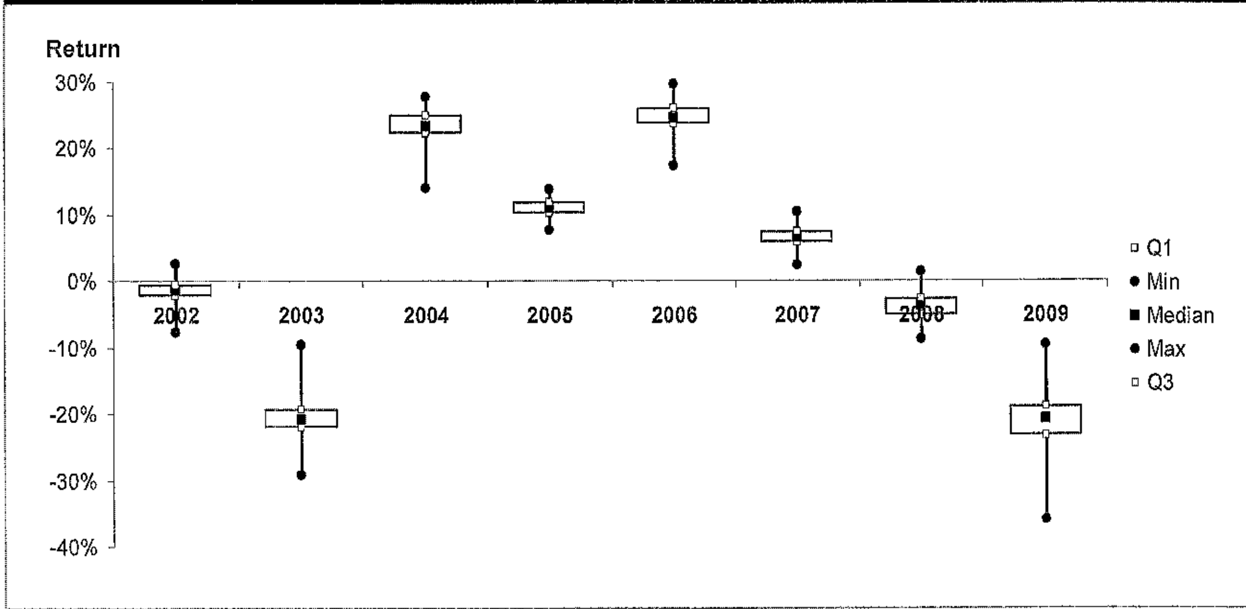
Graph 6. Financial return per country



The substantial volatility in the financial returns of the LGPS funds is striking. The effects of the two financial crises are clearly visible. The returns range from -19.7% during the dot com crisis to +24.7% in the post-crisis boom and back to -20.7% during the credit crisis. Over the period 2002-2009, the LGPS funds realised an average annual return of 1.7%.

Graph 6 depicts the performance of the LGPS per country. Looking at the returns of each fund, there is a large spread in the performances achieved. Graph 7 shows this disparity.

Graph 7. Spread in financial return



For each year, a box plot is drawn showing the distribution of the observations (the financial returns of the LGPS funds). The box contains the observations between the first and third quartiles, meaning it contains 50% of the observations and also the median observation. The two dark dots outside of the box are the highest and lowest observations.

The spread between financial returns increased during the crisis years. Although less pronounced, large differences exist between the investment returns of the various LGPS funds. The difference between the worst and best-performing LGPS funds is around 10 percentage points, whereas during the crisis years 2003 and 2009 it was more than 20 percentage points.

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Comparison with a benchmark return

To see whether the LGPS funds performed better or worse than the financial markets, we had to construct a benchmark with which to compare the financial return. Given the variety of asset classes used in the LGPS funds, we matched these with the appropriate benchmarks. They can be found in table 2.

Table 2. Benchmarks per asset class

1. Total equities	**Benchmarks**
1.1 Total equities UK	MSCI UK index (Net return)
1.2 Total equities outside UK – worldwide	MSCI World index excluding UK (Net return)
1.3 Equities when cited without UK/overseas split	MSCI World index (Net return)
2. Fixed income	
2.1 Fixed income UK – sovereign and corporate	Barclays Government – UK index
2.2 Fixed income overseas - sovereign and corporate	Barclays Government – World index
2.3 Fixed income cited without UK/overseas or corporate/sovereign split	Barclays Government – World index
3. Index-linked	
3.1 Index-linked UK	Barclays Inflation Linked – UK index (Clean price index)
3.2 Index-linked worldwide	Barclays Inflation Linked – World index excluding UK (Clean price index)
3.3 Index-linked cited without UK/overseas split	Barclays Inflation Linked – World index (Clean price index)
4. Real estate/property	
4.1 Property UK – direct or pooled	MSCI Real Estate – UK index (Net return)
4.2 Property overseas – direct or pooled	MSCI Real Estate – World index excluding UK (Net return)
4.3 Property cited without UK/overseas or direct/pooled split	MSCI Real Estate – World index (Net return)
5. Other[1] – such as mutuals and other pooled vehicles, UK or overseas	50% MSCI UK index (Net return) 50% Barclays Government – UK index
6. Hedge funds	Absolute benchmark – 8% annually
7. Currency overlay	0%
8. Cash	0%

A weighted average method was applied to the asset mix of the various funds to create a *benchmark return* for each fund. In other words, the benchmark return equals the relative size of the asset class multiplied by the corresponding benchmark. For this comparison, we used the net asset returns. Therefore, as we did not deduct, for example, the investment costs, outperformance as stated in this report is a conservative estimation.

[1] The 'other' category includes mutual funds and other pooled vehicles for which no clear benchmark exists. However, due to the relative size (15% of the asset mix in 2009), it has a large impact on the benchmark return. A qualitative check, using various annual reports, indicated that the 'other' category appears to contain mostly equity-like assets. Therefore, an assumption had to be made on the return:

- We assumed a certain asset mix within the 'other' category. We decided to use a 50/50 split between UK bonds and UK equities. This reflects the market behaviour and deals with the home (UK) bias that the LGPS funds tend to have.

Other options we considered but returned less accurate results were:

- Use an absolute return, e.g. 4% or 5% annually, taking into consideration that pension funds should be able to make this profit on a long-term basis. However, this overlooks any market fluctuation.
- Use the average return of the fund obtained by the current asset mix of that fund as the 'other' benchmark. That would mean the 'other' category being treated as an average of the asset mix.

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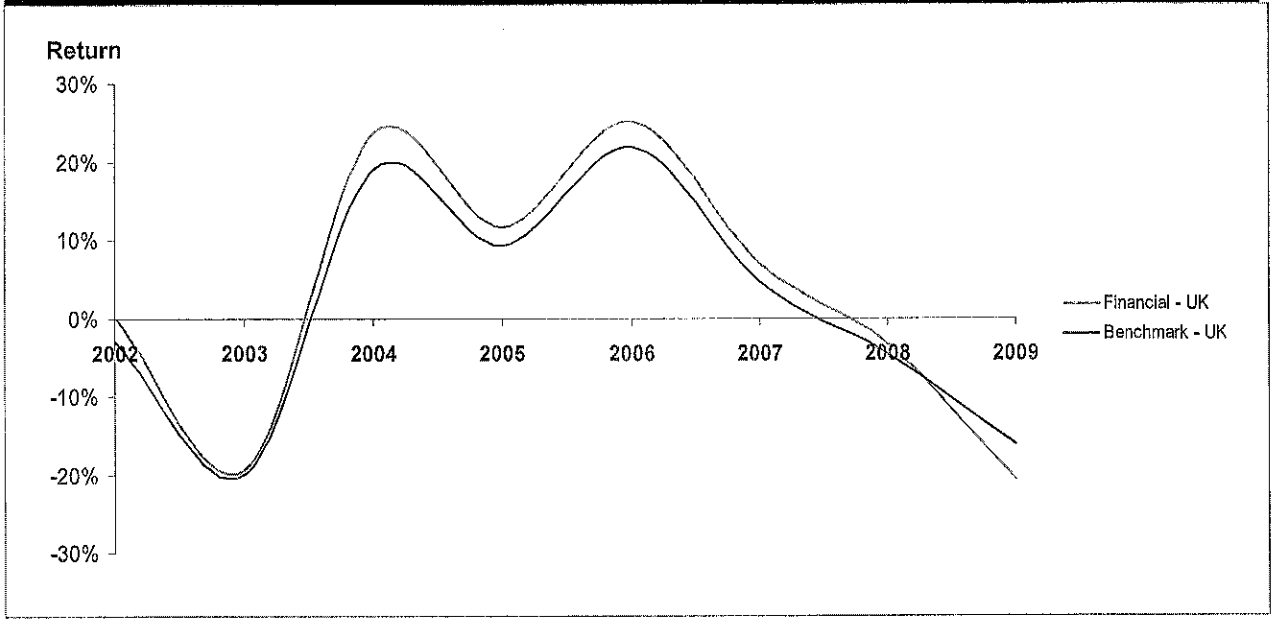
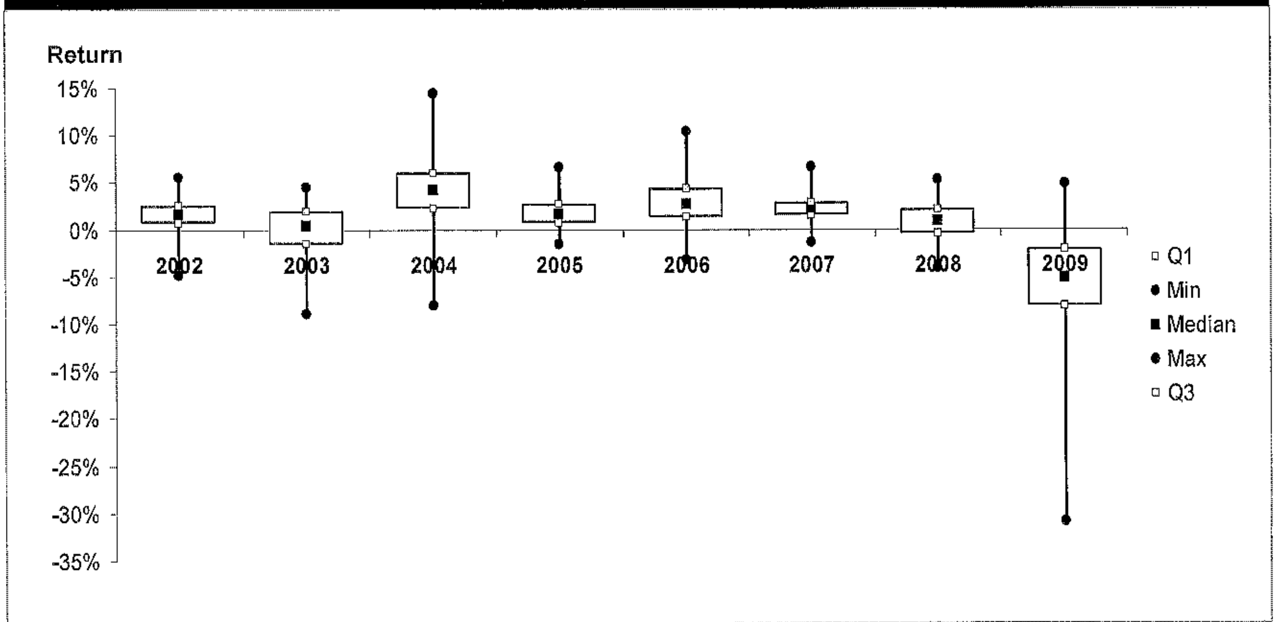
Graph 8. Average financial return and benchmark return

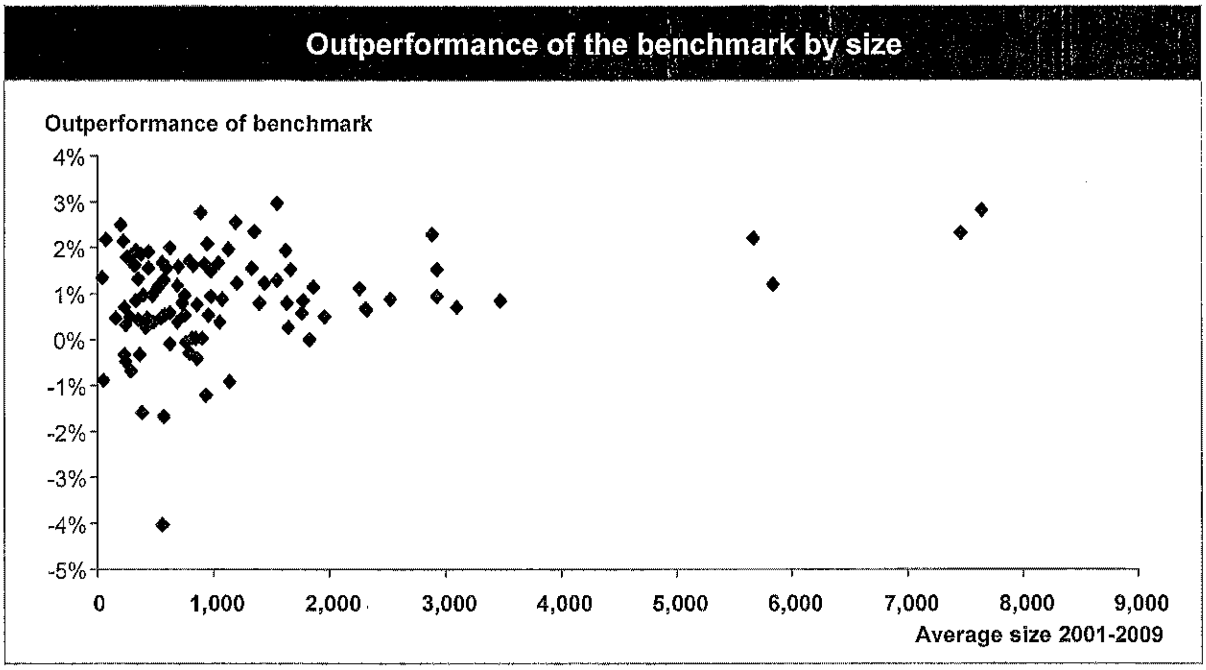


Graph 8 shows the financial and benchmark return for the UK. On average, the LGPS funds outperformed the benchmark by 0.96 percentage points. The outperformance is defined as the financial return less the benchmark return. Graph 9 shows the outperformance in percentage points. Overall, most funds outperformed the benchmark. Large differences exist between the different funds, with some underperforming the benchmark by 3 to 9 percentage points (except 2009, in which one fund's return was 30 percentage points lower than the benchmark).

Graph 9. Spread in outperformance



To see which funds performed better than others and whether size matters (and as such whether a case can be made for consolidation), we plotted the average size of the funds against the annual outperformance of the benchmark. The results are displayed in graph 10.



While there is a wide variety of outperformance among smaller funds, the larger funds consistently outperformed the benchmark. The four largest funds have a weighted average annual outperformance of 2.2 percentage points. Therefore, from a financial return point of view, there seems to be a case for merging the LGPS funds in order to increase the return they achieve – this holds especially for the smaller funds.

Prognosis 2010
Given the benchmark return and average outperformance, it is possible to produce a prognosis of the value of the assets of the LGPS funds at the end of 2010. Table 3 shows that the assets of the LGPS are likely to have risen from £121 to £160 billion in 2010, a rise of 33%.

Table 3: Projection of 2010 asset value (all figures in £ billion)

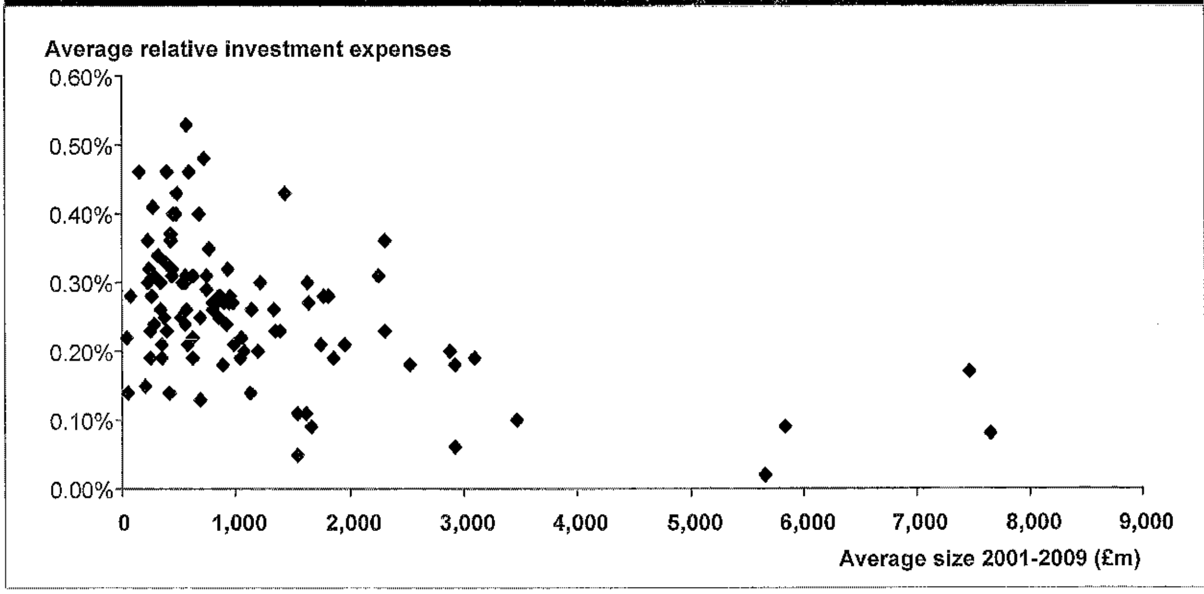
	Benchmark return2010	Actual Asset value 2009	Predicted asset value 2010	Including LGPS outperformance
England	31.8%	96.8	127.2	128.3
Northern Ireland	28.6%	6.2	7.9	8.0
Scotland	34.4%	15.7	21.0	21.4
Wales	31.5%	2.5	3.3	3.3
Total		121.1	159.4	160.9

Economies of scale

Investment expenses

Besides a higher return, we would also expect to see lower costs for the larger funds, due to their ability to exploit economies of scale more efficiently. We have tested this for both the investment management expenses and the administration expenses. In graph 11 we explore the relationship between the investment expenses as a percentage of total assets and the average size of the funds. It appears that larger funds do indeed have lower investment expenses.

Graph 11. Average relative investment expenses by size, 2001-2009



However, this scatter plot does not capture the effect that the asset mix can have on investment expenses. For example, a fund with a large mandate of hedge funds will obviously have higher investment expenses. We therefore had to 'clean' the data for the asset mix. To do so, we had to reconstruct the data into a panel data series in order for us to run a regression[2] with year fixed effects.

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[2] Panel data set:

- Individual series: 101 funds
- Time series: 2001-2009
- Unbalanced due to missing observations

Regression equation:

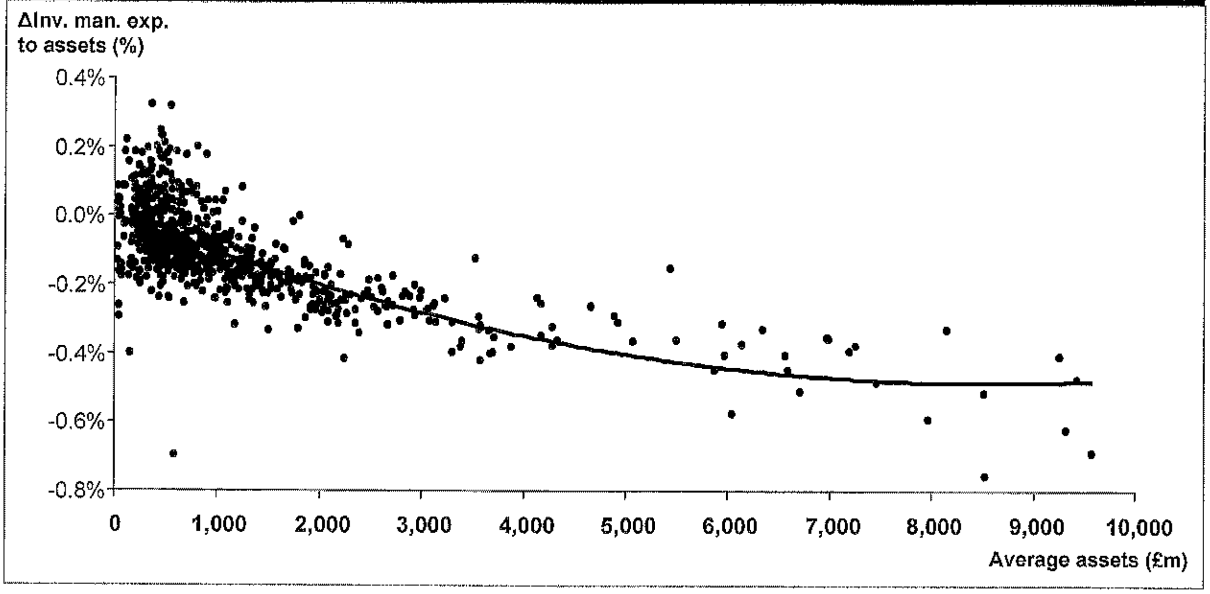
$inv.exp.to.assets_{i,t} = \beta 1 * avg.assets_{i,t} + \beta 2 * sq.avg.assets_{i,t} + \beta 3 * equity.to.assets_{i,t} + \beta 4 * bonds.to.assets_{i,t} + \beta 5 * ilb.to.assets_{i,t} + \beta 6 * realestate.to.assets_{i,t} + \beta 7 * other.to.assets_{i,t} + \beta 8 * hedgefund.to.assets_{i,t} + \beta 9 * currency.to.assets_{i,t} + \beta 10 * cash.to.assets_{i,t} + \beta 11 * d.inv.exp_{i,t}-1 + YFEt + \varepsilon_{i,t}$

where

inv.exp.to.assets equals (investment manager expenses/total assets) for company i in year t; avg.assets equals (average assets = [total assetst + total assetst-1] / 2); sq.avg.assets is the square of avg.assets; equity.to.assets equals (total equities/total assets); bonds.to.assets equals (total fixed income/total assets); ilb.to.assets equals (index-linked bonds/total assets); realestate.to.assets equals (real estate/total assets); other.to.assets equals (other/total assets), 'Other' consists of mutuals and other pooled vehicles; hedgefund.to.assets equals (hedge funds/total assets); currency.to.assets equals (currency overlay/total assets); cash.to.assets equals (cash/total assets); d.inv.exp equals the 1-year lagged investment manager expenses and YFE are year fixed effects.

The results can be seen in graph 12. The y-axis shows the percentage point change in investment management expenses relative to assets. The dots show the relationship between size and investment management expenses. The red line shows the relationship between squared size and investment management expenses.

Graph 12. Investment management expense ratio and size



Since the number of observations above £4 billion is limited, one should be cautious not to overestimate the effect of higher asset value. Nevertheless, we can deduce some results from the regression and find that investment expenses decrease (as percentage of total asset size) by up to 0.3 percentage points when a fund's asset size increases from £1 billion to £8 billion.

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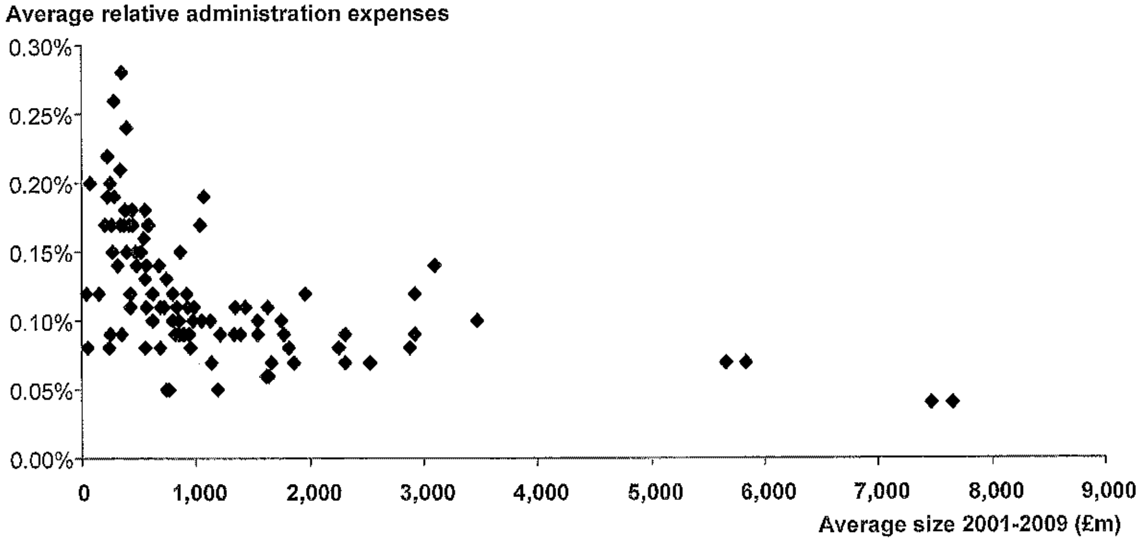
Administration expenses

A similar approach was used to see whether size affects administration expenses. We plotted the administration expenses relative to assets in graph 13.

Graph 13. Average relative administration expenses by size, 2001-2009



A similar regression model[3] was built. Graph 14 shows the results of the regression. In this case, the regression was cleaned for the population underlying the fund: the number of active members, deferred members and retirees. Again, the dots show the relationship between size and administration expenses. The red line shows the relationship between squared size and administration expenses.

[3] Panel data set:

- Individual series: 101 funds
- Time series: 2001-2009
- Unbalanced due to missing observations

Regression equation:

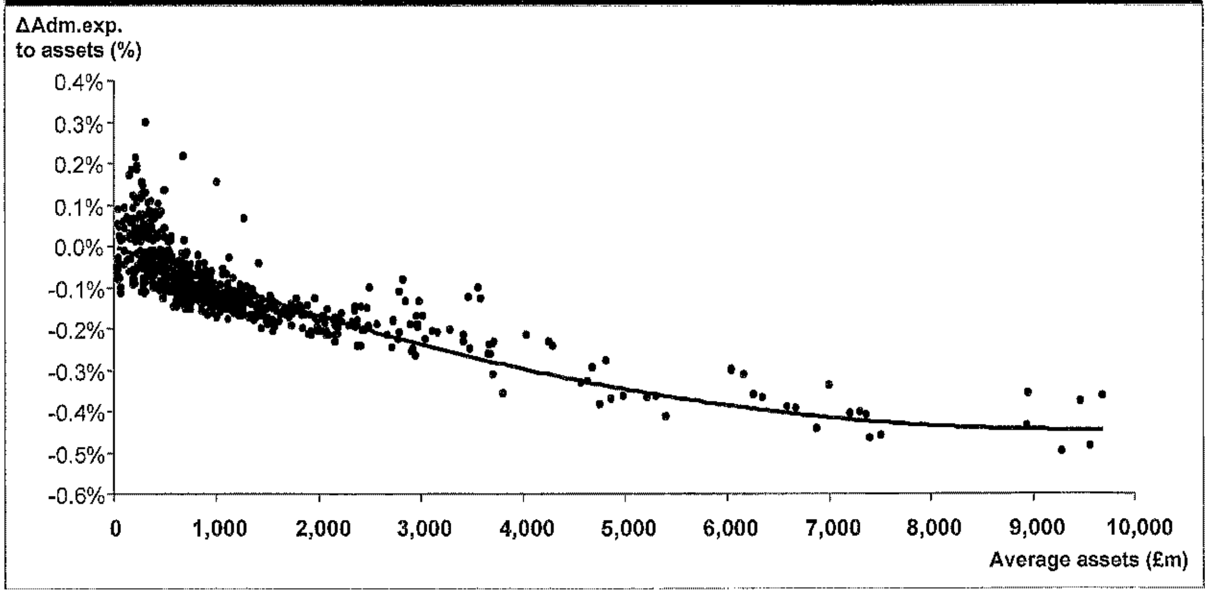
$Adm.exp.to.assets_{i,t} = \beta 1 * assets_{i,t} + \beta 2 * sq.assets_{i,t} + \beta 3 * active.pop_{i,t} + \beta 4 * deferred.pop_{i,t} + \beta 5 * retired.pop_{i,t} + FFEt + \varepsilon_{i,t}$

where

adm.exp.to.assets equals (administration expenses/total assets) for company i in year t; sq.assets is the square of assets; active.pop equals the active population of company i in year t; deferred.pop equals the deferred population of company i in year t; retired.pop equals the retired population of company i in year t; FFE are firm fixed effects.

Administration expenses decrease by up to 0.15 percentage points when an £8 billion fund is created.

Graph 14. Adminstration expense ratio and size



Simulations: effect of mergers

To see what the effects of mergers could be, we simulated a regional consolidation model. In this model, we merged funds in 2001 and saw what effects – measured in terms of asset value in 2009 – lower investment expenses (in line with the regression model built) and higher outperformance (in line with the outperformance by the large funds) have. The question that the simulation answers is how much the assets of the LGPS funds would have increased by in the period to 2009 if all the LGPS funds had performed like the four largest LGPS funds during the period 2001-2009?

To determine which funds should be merged, we set two criteria: they had to form a new fund of approximately £8 billion, and there had to be a geographical fit between the merged funds. For the latter criteria, we used the division of funds found on the LGPS website.

The country was split up in:
- London area
- Midlands
- South West
- South East
- North
- Scotland
- Wales

The exact division of funds can be found in appendix 1.

Source: LGPS website

The reasoning behind lower investment costs and higher returns is that economies of scale can be better exploited and the investment expertise of more successful funds can be used for the large funds, eliminating the lower returns of less-performing funds.

The end-value of assets in 2001 were used as a starting point for the simulations. The cash flows of the funds were kept constant, as was the asset mix. The benchmark returns were plugged in for the different asset classes and topped up with the average weighted outperformance by the four largest funds to reflect the actual investment performance of these funds.

In a second simulation, the investment expenses were decreased according to the effects of an increase in asset size that we determined via the regression. The results can be found in table 3.

Table 4 – all figures in £m

Group	London 1	London 2	Midlands 1	Midlands 2	South East 1	South East 2
Reduction in investment expenses	66.3	64.1	63.7	72.7	63.2	65.5
Outperformance by four largest funds	1,000.5	1,333.4	1,130.9	250.6	1,631.5	1,361.0
Group	**North 1**	**North 2**	**North 3**	**South West**	**Wales**	**Scotland**
Reduction in investment expenses	85.3	90.6	56.8	65.1	41.4	58.4
Outperformance by four largest funds	446.7	99.8	583.0	840.1	158.9	772.0

The figures reflect the increase in value over the period 2001-2009 under the simulations. For this period, the total effect of a reduction in investment expenses is £793 million. Capturing the outperformance by the four largest funds would have resulted in a total of £9.6 billion extra assets at the end of the period 2001-2009. The London and South Eastern funds in particular would have benefited greatly from a higher investment performance. For Midlands 2, North 1 and 3 the difference is relatively small because those groups each contain one of the four largest funds.

The substantial increase in assets is explained by the principle of compound interest. Small differences can result in large increases over a longer period.

Larger fund size

A fund of approximately £8 billion is not necessarily the optimum size for a pension fund. Evidence from the Netherlands shows that the sophistication of investment policies increases and the risk/return profile improves with fund size.[4] Further consolidation of the LGPS funds could therefore improve their financial results even further.

One LGPS fund could, for example, be created for England and one for Scotland.[5] Under the current simulation, the English funds gain £9.4 billion over the period 2001-2009 by matching the performance of the four largest LGPS funds, and the Scottish funds gain £830 million. Creating one fund each for England and Scotland would most probably lead to even larger gains.

Regrettably it was not possible within the scope of this study to estimate the gains from a consolidation to form larger LGPS funds. It would be interesting to analyse the performance of UK pension funds above the size of £8 billion and what this means for the LGPS funds. We leave this for future research.

[4] J. de Dreu & J.A. Bikker, Pension fund sophistication and investment policy, DNB Working Paper No. 211, May 2009.
[5] Northern Ireland already has one pension fund, and the simulation included just one fund for Wales.

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Appendix 1 – Regional grouping of LGPS funds

North 1		
Cumbria	CBA	992.53
East Riding	ERD	1,614.75
Northumberland	NHB	518.91
North Yorks	NYK	828.82
Teesside	TEE	1,700.87
West Yorks	WYK	5,931.49
Total		11,587.37

South East 1		
Beds	BED	887.42
Berks	BER	1,009.05
Essex	ESS	2,224.81
Herts	HER	1,639.58
IOW	IOW	209.92
Kent	KEN	2,060.38
Suffolk	SUF	1,037.19
Surrey	SUR	1,346.37
Total		10,414.72

South East 2		
Bucks	BUC	1,007.41
Cambs	CMB	1,100.46
East Sussex	ESU	1,381.99
HamFul	HAF	420.87
Hants	HMP	2,396.10
Norfolk	NFK	1,476.38
Oxon	OXF	796.64
West Sussex	WSU	1,237.40
Total		9,817.24

Midlands 1		
Cheshire	CHE	1,855.27
Derbys	DBY	1,758.79
Leics	LEI	1,512.60
Northants	NHT	868.49
Notts AB	NAB	61.91
Notts Main	NOT	1,960.46
Shrops	SHR	716.16
Warks	WAR	820.30
Worcs	WOR	920.86
Total		6,160.17

Midlands 2		
West Mids	WMD	6,017.71
Staffs	STF	1,688.37
Lincs	LIN	890.45
Total		8,616.14

North 2		
Durham	DUR	1,245.52
GMPF	GMR	7,761.56
Total		9,007.08

London 1		
Barking Dagenham	BKG	413.09
Barnet	BNT	481.92
Bexley	BEX	326.31
Brent	BRE	345.45
Bromley	BRO	299.27
Camden	CMD	620.62
Corp London	CIT	414.90
Croydon	CRO	417.04
Ealing	EAL	434.83
Enfield	ENF	441.75
Greenwich	GRE	528.68
Hackney	HAC	542.42
Haringey	HGY	487.51
Harrow	HAR	307.42
Havering	HAV	262.65
Hillingdon	HIL	417.43
Hounslow	HOU	392.32
Islington	ISL	538.19
Lambeth	LAM	540.75
Total		8,212.55

London 2		
Kenchel	KCH	332.32
Kingston	KIN	279.14
Lewisham	LEW	518.85
LPFA	LPF	3,019.92
Merton	MTN	260.76
Newham	NEW	501.68
Redbridge	RED	313.11
Richmond	RCH	271.93
Southwark	SWK	598.21
Sutton	SUT	244.23
TowerHam	THM	562.33
Waltham F	WAL	340.18
Wandsworth	WAN	545.76
Westminster	WMR	483.24
Total		8,271.65

North 3		
Lancs	LAN	2,933.94
Merseyside	MSY	3,521.50
South Yorks	SOY	3,082.53
Tyne & Wear	TYW	3,102.73
Total		12,640.69

Scotland		
Aberdeen Main	ABM	1,416.06
Aberdeen No 2	AB1	44.09
Dumfries Gal	DUM	355.42
Falkirk	FAL	783.51
Fife	FIF	843.95
Highland	HLD	627.77
LothianMain	LOT	2,311.62
Orkney	ORK	92.94
ScotBordMain	SCB	235.74
Shetland	SHE	158.10
Tayside	TAY	1,240.91
Total		8,110.11

South West		
Avon	AVO	789.02
Cornwall	COR	1,782.58
Devon	DEV	999.11
Dorset	DOR	737.46
Gloucs	GLO	762.25
Somerset	SOM	845.17
Wilts	WIL	1,819.08
Total		7,734.67

Wales		
Cardiff	CDF	759.62
Clwyd	CYD	697.41
Dyfed	DYF	890.45
Gwynedd	GWY	658.19
Powys	POW	258.95
Rhondda	RHO	1,111.71
Swansea	SWA	735.69
Torfaen	TOR	1,048.17
Total		10,474.83

The funds in bold type are the four largest, which are used in the simulations.

Two funds are not included:
- the Northern Ireland fund
- **Strathclyde1** (Scotland)

UNISON
the public service union

Independent Public Sector Pensions Commission (IPSPC)

UNISON Submission on Local Government Pension Scheme Governance and Fund Economics

This submission addresses the Commission's question 22

"Is there scope for rationalising the number of local government pension funds? If so, how could this be achieved?"

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Introduction

This submission is made in response to the call from the Commission for further evidence that should be made on the structural issues laid out in the IPSPC's preliminary report. It also delivers further evidence on the issues we highlighted in our first submission, namely evidence on the benefits of LGPS fund merger.

The Commission's first report also highlighted the fact that governance of public service pension schemes, and the question of who is ultimately responsible for them, seems to lack clarity.

We have therefore also included specific material on the legal framework under which the LGPS is governed, in particular the implications and duties of the UK Government in respect of Directive 41/2003: Institutions for Occupational Retirement Provision, commonly known as the IORP Directive.

Summary points of this submission

- UNISON's legal advice is that the LGPS should be subjected to the requirements of Directive 41/2003 Institutions for Occupational Retirement Provision and in particular Articles 8 and 18

- Under these articles the LGPS must be legally separated from the sponsoring employers. Investments must be made in the best interests of scheme members and where conflicts of interest arise, they must be resolved in the favour of scheme members

- We suggest the most appropriate approach for achieving this obligation would be to create non-departmental government bodies to undertake the responsibilities of delivering the LGPS benefits.

- There are considerable savings to be made from reductions in fund management costs and significant increases in income from fund merger, UNISON estimates that up to £1bn additional annual income could be made from fund mergers and additional economies of scale

- Based upon our own research we commissioned an investigation into the last 10 years of investment strategy, performance, fund management costs and the economic benefits of fund merger

- This research work was carried out by APG (All Pension Group) the fund managers for the Netherlands public sector pension scheme ABP. It established the following:

    - Based upon a LGPS model made of 14 funds rather than the current 101, and each with no less than £8bn under management, gross investment income rose between 2001-2009 by a total of £10.4bn

- These income increases are equivalent to £624 per active (contributing) member per year – a figure we estimate to be around 2.7% of payroll[1]

- This means there would be no need to increase member contributions by 3%

- From 2001 to 2010 there could have been an income increase of £30bn in asset value.

- We believe that fund merger offers the government the opportunity to create a modern and effective basis for the management of the scheme's assets going forward and that the economic benefits of fund mergers should be shared between employers, (tax payers) and employees.

- UNISON believes that before any change to the LGPS retirement age contributions or benefits is made fund merger is thoroughly considered and acted upon.

Section 1: LGPS Governance and the EU Directive 41/2003 Institutions for Occupational Retirement Provision (IORP)

The DWP is responsible for the incorporation of the provisions of the IORP Directive into UK law. For the majority of funded pension schemes, which are trust-based, the requirements of the IORP Directive are incorporated in the 2004 Pensions Act. (Pay-as-you-go schemes, including pay-as-you-go public sector schemes such as the NHS, Civil Service Teachers, Police and Armed Forces schemes, are exempt.)

All funded schemes underwritten by Statute, including the LGPS, can be made exempt from Articles 9 to 17, by Government application for exemption. But no exemption is permissible for Articles 8 and 18.

Implications for the implementation of the Directive

The purpose of the Directive is to secure the prudential supervision of pension schemes or, in Euro-jargon, "institutions for occupational retirement provision" or IORPs, as major financial institutions which have a key role to play in ensuring the integration, efficiency and liquidity of financial markets. Each LGPS fund is an IORP for these purposes.

Drawing on our Counsel's opinion, which has been submitted to the DCLG the application of Articles 8 and 18 of the IORP Directive have implications under the following headings:

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1. UNISON supplementary paper calculating benefits of fund merger for payroll

Article 8 requires the legal separation of the institution between the sponsoring undertakings (employers) and IORPs (the funds).

This requirement has the following implications:

- All LGPS institutions should have separate bank accounts, independent audits and accounts. (This is currently not the case in many of the smaller schemes).

- They must be operated as stand-alone funds, meaning that loans to and from the pension scheme must be transparent and at arm's length (see further below). They must not be used as a financial reserve for the employing authorities and must be insulated from the other financial liabilities of the employers.

- They must be separately managed. That is not to say that elected members may play no role in the running of the fund, but proper arrangements must be put in place for identifying and managing conflicts of interest.

Article 18, opening sentence - Investments to be made in accordance with the "prudent person" rule. In the context of UK law, that means that the relationship between the members of the pensions committee and the scheme members must be recognised as fiduciary.

Investment decisions must be driven by the need to maximise the fund value, and not, for instance, to ease liquidity problems for the employers.

This requirement has the following implications:

- The current LGPS regulations make no reference to this requirement, and are therefore non-compliant.

- Investments must be made at arm's length. Loans from the pension fund to the employers must be at a proper commercial rate of return. That will improve the funding position of the pension funds but will correspondingly weaken the financial position of the employers.

- Up until April 2010 loans to the employers of up to 10% of the value of the fund were permissible at 7 day Libor. We estimate that no less than £2.75bn was on loan in the financial year 2008/09, and as a result fund income was probably not maximised.

- Employers will be able to charge an administration fee for managing the pension fund's assets only on an arm's-length basis. Currently some pension fund investments are co-mingled with the authorities' other investments and the authority charges a fee for joint administration.

Article 18 (a) “the assets shall be invested in the best interests of members and beneficiaries. In the case of a potential conflict of interest, the institution, or entity which manages its portfolio, shall ensure that the investment is made in the sole interest of members and beneficiaries”

This requirement has the following implications:

- Councillors are currently bound by a fiduciary duty to taxpayers, which places them in a conflict of interest when making decisions regarding an IORP-compliant fund.

- DCLG recognises that there is a problem here, and promised statutory consultation, which unfortunately did not materialise. In the interim, members of pensions committees who make decisions in the best interests of scheme members are theoretically at risk if they refuse to make “investments” in the form of loans or building projects that would benefit taxpayers, even if they are recommended to do so by officers.

- Employer-nominated trustees in the private sector have similar conflicts, but the Pensions Regulator expects conflicts to be properly declared and managed. He has just issued a draft code of practice on the subject

Our Counsel believes it is not enough that councillors on pensions committees be instructed to be solely concerned with the interests of members and beneficiaries. Rather, there must be a practical method of demonstrating that the Directive is complied with, and the Institution (the individual LGPS funds) must be in a position to exercise independence from the employer/s.

Counsel believes this may mean:

- That council officers should not take part in the decision-making on fund matters, at best they should only advise. By example, West Yorkshire LGPS has excluded the Director of Finance of Bradford council from the pensions committee.

- That the further protections available in the 2004 Pensions Act should be taken as the only adequate model for LGPS compliance. In particular, the benchmark should be taken to be private sector arrangements for the appointment of member-nominated representatives with full powers and access to training and facilities.

- There should be improved standards of consultation with scheme members

- Pension committees should appoint legal, investment and actuarial advisors whose duty it is to act for them where there is a conflict with employers.

Article 18(b) - (e) - the fund assets must be invested in such a manner as to ensure the security, quality, liquidity and profitability of the portfolio as a whole.

- Assets held to cover liabilities must be invested in a manner appropriate to the nature and duration of the expected future retirement benefits;

- The assets must be predominantly invested on regulated markets. Investment in assets which are not admitted to trading on a regulated financial market must in any event be kept to prudent levels;

- Investment in derivative instruments should be possible insofar as they contribute to a reduction of investment risks or facilitate efficient portfolio management. They must be valued on a prudent basis, taking into account the underlying asset, and included in the valuation of the fund's assets. The fund must also avoid excessive risk exposure to a single counterparty and to other derivative operations;

- The assets must be properly diversified in such a way as to avoid excessive reliance on any particular asset, issuer or group of undertakings and accumulations of risk in the portfolio as a whole.

This requirement has the following implications:

- Local authority pension funds will have to adopt modern portfolio investment management practice, matching assets to liabilities in a prudent and transparent manner.

- "Investments" by way of loan to the employers will have to be transparent.

- Fixed interest investments should be predominantly made by way of traded Treasury and corporate bonds and not unregulated loans to the employers

Finally, Article 18(f) - investment in any one employer must not exceed 5% of the portfolio as a whole and, when aggregated with other investments in all local authorities must not exceed 10% of the portfolio. Investment in these sponsoring undertakings shall be made prudently, taking into account the need for proper diversification.

In summary, UNISON has long argued for improved governance of the LGPS, in terms of securing proper returns, transparency and greater scheme member representation on the LGPS funds. Compliance with the Directive would assist those goals. Any cost burden on Administering Authorities arising from compliance with the IORP Directive is likely to be substantially reduced if investment funds are merged.

We would suggest the most effective and efficient means to achieve the legal separation would be to create new management organisations using the DCLG's ability to establish them as 'Non-departmental government bodies'. Such organisations are already established to run a handful of LGPS funds, such as the Environment Agency, the London Pension Fund Authority and the South Yorkshire Passenger Transport Authority.

In the United Kingdom, a non-departmental public body (NDPB) is a classification applied to certain types of public bodies. They are not an integral part of a government department and carry out their work at arm's length from Ministers, although Ministers are ultimately responsible to Parliament for the activities of bodies sponsored by their department.

Under this constitutional arrangement the funds and the scheme can remain under the operation of the state and of Parliament. The rules applied to trust based schemes would be avoided, such as the ability to repay deficits over a longer time period than a trust.

It will be necessary to appoint individuals to these organisations to administer the funds. As in the private sector one would expect the appointees to reflect a mixture of employer and member representatives.

The new management boards will need to have a constitution that demonstrably seeks to eliminate conflicts of interest in cases where investment decisions may not be in the interest of beneficiaries. [2]

Section 2 LGPS Fund Economics and Merger

The Commission's first report suggested that there was evidence for the benefits of fund mergers and indeed the DCLG in its submission suggested the same.

We have submitted detailed papers on fund economic performance and the benefits of fund merger. We believe that the evidence submitted on fund economics and the financial benefits of merger warrant a much closer examination and indeed implementation. [3]

We believe that fund merger offers the government the opportunity to create a modern and effective basis for the management of the scheme's assets going forward. The LGPS has three sources of income – Employer contributions, Member contributions and Investment Income. Investment income itself arises from two sources – regular dividend (and interest) payments arising from ownership of assets, and capital gains (or losses) arising from the sale of assets.

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[2] UNISON supplementary evidence: Local Government Pension Scheme Governance Analysis England and Wales 2009

[3] UNISON supplementary evidence: Local Government Pension Fund Economic Performance England, Scotland and Wales and Wales and England Fund Merger

Most funds are "actively" managed – which is to say that they retain fund managers who buy and sell stock over the course of the year (i.e. as distinct from the meaning of "shareholder activism", which is adopted only in a limited way by most funds). For the investor community as a whole, such speculative short-term buying and selling on the stock market is a zero-sum game.

The costs of fund management now average 11% of annual dividend and interest income in the LGPS,, that is for every £100 of gross dividend and interest income, £11 goes straight back to the financial intermediaries. In some cases this rises to above 50% a quite shocking situation.

It seems inevitable therefore that larger LGPS funds (with greater resources for speculative activity) are in part penalising smaller LGPS funds with less aggressive or less responsive speculative market trading. In any case, the LGPS funds are currently competitors in the market, rather than collaborators.

We suggest that any discussion of the future structure of the LGPS must include a complete review of investment practice, with the participation of trade union scheme member representatives and a professional panel appointed by them.

Such a review should include consideration of:

The appropriateness of current valuation methods and its impact on the current approach to scheme sustainability:

- The most effective number and size of funds.
- The costs to the scheme of externalised functions
- The SORP method of valuation (adapted from FRS17 standards in the private sector), includes a requirement that funds must approach full funding at all times -- in case of sponsor bankruptcy -- including during stock market slumps. This approach creates a stop-go obligation on contribution rates, and places higher pressure on employers during recession, but offers "holidays" or contribution reductions during booms – exactly the reverse of a sensible approach to long-term savings provision.
- The LGPS is, in principle, is a scheme with a very long term horizon, where bankruptcy is not as great a concern as in the private sector, and where the improvement of a flow of investment income should be a higher priority than temporary movements in underlying asset values.
- Despite the low market values for assets, especially at March 2009, the LGPS is currently strongly cash positive, (benefits paid out in 2008-09 were £5.6bn, against a gross income of £10.2bn).

Methods for improving investment income:

- Through a detailed review of recent investment practice across the LGPS and sister funds abroad, with particular attention to asset mix and the role of hedging.
- By exploring the creation of lower-cost investment vehicles, in conjunction with specialists especially where these replace high-cost

Private Equity investments, and especially in infrastructure, where scheme member investments may be undermining pay, working conditions and local living standards.
- By discouraging Fund Managers from churning stock, and focusing on business and broader economic governance
- By obliging fund managers to pool research within the LGPS family.

Reduction in Investment Management costs
- Through fund mergers
- By encouraging funds to negotiate more appropriate fee structures (e.g. based on investment income and fixed fee governance duties, not asset valuation and brokerage turnover)

APG: Independent verification of the benefits of fund mergers[4]

APG or All Pension Group is the fund management arm, wholly owned by the Dutch pension fund ABP. APG is the world's third largest pension fund manager and is specialised in the administration of collective pensions.

APG Group serves over four million pension fund members in the sectors education, government, construction and housing corporations. APG manages over € 280 billion of pension assets on behalf of these sectors. APG has offices in Amsterdam, Heerlen, Hong Kong and New York.

APG are also expert in the process of fund and scheme mergers and have a done so across the Netherlands and the European Union.

UNISON asked APG to evaluate the investment performance of the Local Government Pension Funds over the period 2001 to 2009. The Local Government Pension Scheme (LGPS) is administered by 101 separate funds in England, Northern Ireland, Scotland and Wales.

This unique structure allows for comparisons between the different funds and examination of the merits of merging funds to exploit economies of scale.

Even though the LGPS has a good investment record on average, large differences exist between the funds. The difference in investment return between the best and worst performing funds is 10 percentage points in normal years and 20 percentage points during the dot com and credit crises.

Given these differences between funds, their research shows that substantial improvement in investment performance could be realised by increasing the size of funds. They found the following effects:

- Investment expenses and administration costs as a percentage of assets decline when the size of the fund increases. Investment expenses decrease by up to 0.3 percentage points of assets, and

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[4] UNISON supplementary evidence: Performance analysis of LGPS funds by APG

administration costs by up to 0.15 percentage points of assets when a fund of £1 billion merges to a fund size of £8 billion.

- Larger funds consistently achieved higher investment returns over the period 2001-2009. The four largest funds outperformed the benchmark on average by 2.2 percentage points, ranging from 1.2 to 2.8 percentage points.

- Simulations of a regional consolidation scenario for the period 2001-2009 show that, applying the outperformance by the four largest funds, the other funds could collectively have reported an extra £9.6 billion in assets in 2009.

- Similarly, reductions in investment expenses in line with the increase in assets due to consolidation could in total have led to an extra £793 million over the period 2001-2009.

The above results may be improved upon by using more detailed data on the LGPS funds. Return data on individual asset classes may, for example, show why larger funds outperform smaller ones. Unfortunately however, the reporting standards currently required for LGPS schemes do not allow such a detailed comparison.

We believe a closer analysis of performance variations, especially among the largest 4 LGPS funds, may offer further evidence to ensure best practice investment strategy.

The preliminary results show that more pension money will be left for the LGPS members if the institutional set-up of the LGPS is changed. Dividing the sum of the additional return on assets (£9.6 billion) and the additional assets due to lower expenses (£793 million) by the total number of members of the LGPS funds, we find that every LGPS member (i.e. all contributing, beneficiary and deferred members) gains an average of £275 a year for the period 2001-2009 if the LGPS funds are merged to form 14 regional funds.

A fund of approximately £8 billion is not necessarily the optimum size for a pension fund. Evidence from the Netherlands shows that the sophistication of investment policies increases and the risk/return profile improves with fund size.

Further consolidation of the LGPS funds could therefore improve their financial results even further. One LGPS fund could, for example, be created for England and one for Scotland.

Under the current simulation, the English funds gain £9.4 billion over the period 2001-2009 by matching the performance of the four largest LGPS funds, and the Scottish funds gain £830 million.

Creating one fund each for England and Scotland would most probably lead to even larger gains. Regrettably it was not possible within the scope of this study to estimate the gains from a consolidation to form larger LGPS funds. It would be interesting to analyse the performance of UK pension funds above the size of £8 billion and what this means for the LGPS funds.

We believe further research to establish best practice investment models may require the Commission to seek comparable data on investment returns by asset classes, especially for the larger funds.

The Commission could improve scrutiny of LGPS investment performance by requiring comparability of performance reporting. We are happy to provide our views on such standards – which should not increase the burden on Administering Authorities, but merely ensure their comparability.

The process of fund merger

The assets of the different LGPS funds have to be pooled in one vehicle or fund governed by an independent investment management board. When organised with care, this board should be able to deliver the LGPS funds a better return/risk-profile on their assets than the current separate investment commissions. [5]

The larger asset base allows for reduced asset management fees, less asset managers and better resources to retain the best performing asset managers. Taking this further, looking at the asset size of the LGPS funds combined, an internal management company is one of the options as well.

The different LGPS funds can still determine their own strategic asset mix when pooling their assets. Only the array of different assets and asset managers will be limited and determined by the independent investment management board.

The investment management board could for example create two investment funds the LGPS funds to choose from. One investment fund earns a matching return that matches the development of the liabilities and the other investment fund earns an excess return which allows LGPS funds to profit from the upside of financial markets.

This approach allows LGPS funds to determine their own risk-return profile. Of course other approaches with more investment funds are also possible. An important feature of the new vehicle relies on the assets and the investments being managed in the best interest of the participants.

This means that, to prevent conflicts of interest, the vehicle must be independent of the sponsor and the investments must be done according to the prudent person principle. Diversifying the risk does not imply that all assets are pooled in such a way that cross-subsidies between funds occur.

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[5] UNISON supplementary evidence: Restructuring the LGPS funds by APG

By proper accounting, the funds still 'own' their assets and can be assigned at any point in time to the fund, while still reaping the benefits of economies of scale. This way, the assets of a fund with a surplus will not be used to finance the deficit of another fund, which is an unwished-for effect.

Conclusions

The IPSPC confirmed in its first report that the legal status and governance of public sector pension schemes is questionable. Furthermore the report highlighted the fact there were potential grounds to justify the merger of the LGPS funds.

UNISON agrees with both points. This submission on question 22 gives the evidence and practical process for putting the LGPS on an effective legal and economic footing so that the scheme can look forward to a sustainable future.

We have also obtained the expertise of the World's 3rd largest public sector fund managers and pension administrators which clearly agree that the LGPS would gain considerably from fund merger. We have the offices of APG at the union's disposal for their professional assistance in this process.

We have estimated from the APG report that contribution rates of our members need not be subject to a 3% increase.

UNISON believes that the economic advantages of fund merger should be shared equally with scheme members the employers and that these will feed through to taxpayers in the form of lower contribution rates. That any consideration of changes to the current contribution and benefit structures should not take place without first undertaking a thorough economic examination of fund mergers.

We have attached a number of documents which, taken together, address Question 22 in full. They include the following:

1. UNISON research into the economic performance of the LGPS in England, Scotland and Wales
2. UNISON research into the benefits of fund mergers in England and Wales
3. UNISON research into the governance of the LGPS in England and Wales
4. Two reports by the Netherlands public sector fund manager APG: one on evidence for fund merger, and the other on the process of fund merger
5. Notes regarding the impact of APG estimates on contribution rates