Pensions Pathfinder Project Phase II
Interim Report

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Version 1.0

Contents

Executive summary

1. Introduction

The Pathfinder Project ("the Project") was initiated in 2007 to identify the potential for cost savings and operational efficiencies through the adoption of shared services within the Local Government Pension Scheme (the "LGPS") in Scotland. The Project is concerned with the administration and investment management of the LGPS in Scotland and has not considered the design of the scheme or scheme member benefits.

In 2008, following discussion with the Scottish Government, the scope was broadened in recognition of wider opportunities to rationalise and improve the LGPS across Scotland. Phase One of the Project was initiated to consider these opportunities and in 2009 a report was commissioned to carry out research into current management arrangements within the LGPS in Scotland.

Following the publication of the Phase One report, a work plan and strategy for a second phase of research ("Phase Two") was outlined and agreed by the Improvement Service, Scottish Government and COSLA. This plan encompassed further work to identify the most cost-effective, beneficial administration management and investment management models. A steering group of senior local authority officers was established to oversee this next phase of the Project with political guidance and oversight from COSLA.

Deloitte was appointed in November 2011 to carry out the research required under Phase Two 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.

This interim report summarises the findings to date on:

- current and alternative pensions administration options;
- initial research on investment management; and
- governance options.

The report includes recommendations regarding areas for further research on administration and investment management, and activity within a third 'Governance and Implementation Planning' workstream.

Input to this interim report has been provided by pensions officers from each of the 11 funds and by the Scottish Public Pensions Agency.

2. Background to the LGPS in Scotland

The LGPS in Scotland is a funded statutory pension scheme which is currently divided into 11 separate funds with administration and management is carried out by 11 different local authorities which are appointed as administering authorities. Regulations covering the LGPS in Scotland are prepared by the Scottish Public Pensions Agency (SPPA) on behalf of Scottish Ministers under powers conferred on them by section 7 and Schedule 3 to the Superannuation Act 1972.

Elected councillors sitting on committees established within each administering authority act as *de facto* trustees to the relevant funds, and have responsibility for a range of pensions and investment related issues. Each of the current 11 administering authorities is required to create and maintain their membership records throughout the employer participation and membership lifecycles.

3. Investment Management - Initial Research

We have carried out initial research on the alternative models for managing investment assets within the LGPS in Scotland. The models considered are:

i) retaining the current structure; and

ii) merger into one, two or three larger host funds.

We have compared our findings against the current arrangements to consider the costs, benefits and risks of each option against the status quo.

We have been provided with investment data in the form of the LFR24 analyses for the CIPFA (Scotland) Pensions Sub Group. Additional information and data has been provided by the administering authorities and we have conducted interviews with pensions officers at each of the administering authorities. We note that the investment data provided in the LFR24 analyses is heavily caveated with a number of qualifications on the limitations of the data and consistency of the information between authorities, particularly in relation to costs.

To assist in investment manager fee analysis we have sourced indicative fee quotes from a range of investment management organisations as details of individual mandate fee structures and fees paid to individual underlying managers were not provided by the administering authorities due to commercial confidentiality concerns.

Our findings and recommendations are summarised below.

i. Retaining the current structure

Under this option there would be no change to the current structure and investment arrangements, with the current 11 administering authorities retaining responsibility for the day to day investment management of the underlying funds.

Findings

- Whilst we have not been provided with details of individual mandate fee structures, we have been informed that across the 11 administering authorities there are a number of investment mandates that are being operated on competitive investment management fees, in particular where investment mandates have been in place for over 10 years.

- Relative to the trend within the private sector, the 11 funds have retained a far higher allocation of return seeking assets such as equities and property, with an increasing allocation to non traditional or alternative investments, and consequently a lower allocation to less risky investments such as bonds.

- With public sector cutbacks, there is an expectation that public sector schemes will see deferred and pensioner members accounting for a higher percentage of overall liabilities, suggesting that future consideration will need to be given to de-risking strategies i.e. reducing the allocation to return seeking assets and increasing the allocation to less risky bond type investments. Such strategic considerations are likely to increase the level of professional investment expertise needed.

- While extensive use is made of active investment management across the 11 funds, there is no evidence that this has been of benefit at the collective level, with the combined assets having underperformed the combined benchmark by approximately 0.2% p.a. over the 3 years to 31 March 2010. Active investment management incurs higher investment manager fees than passive management but there is no evidence to suggest that at the combined level the payment of these higher investment manager fees has resulted in outperformance.

- It should be noted however that at the individual fund level, there are some funds where the overall management of the assets has been beneficial relative to their respective benchmark in recent years.

- The governance arrangements across the 11 administering authorities vary, with the larger funds delegating elements of the management of the investment arrangements to sub committees. Overall there is less usage of external advice relative to equivalent sized schemes in the private sector. Given a number of funds have introduced, or are increasing their allocation to, alternative investments, compared to equivalent sized private sector schemes there is an apparent lack of external professional investment advice being taken in relation to investment strategies which significantly increase the underlying investment management charges.

- We believe that there are risks linked to the relatively low level of resourcing across most of the funds, leading to a “key man risk”. There are also potential generational issues as individuals with experience and knowledge retire from the administering authority. This is not helped by the fact that membership of the pensions committees is determined following local government elections which has resulted in a lack of continuity and stability in the membership of some pensions committees.

- Regulation currently restricts funds from investing more than 35% of their assets in a single fund or insurance policy to avoid concentration of risk. This could create issues in relation to any potential future decisions to increase the proportion of assets managed on a passive basis in pooled funds.

ii. Merger into 1, 2 or 3 funds

This option considers funds being merged together into 1, 2 or 3 larger funds split broadly by geographical area.

Findings

- We would expect there to be savings in investment management fees on moving from the current structure to 1, 2 or 3 larger funds. However, based on the fee analysis we have undertaken to compare the potential investment manager fees under each of the merger models it appears that the degree of potential savings would be limited. Our analysis suggests the savings would be less than 1 basis point of the total value of assets, namely less than £2m pa across all funds.

- While merger of some individual funds would result in a reduction in the current level of investment management fees, it is likely that in other cases there would actually be an increase given the increased complexity of the investment arrangements of some of the larger funds where these larger funds become future host authorities. There is no clear evidence that improved returns would be delivered by more complex investment arrangements.

- Offsetting any potential savings from lower investment management fees following merger, are the costs that would be incurred moving from the current structure and reducing the overall number of investment managers and mandates to more manageable levels. Whilst the cost of any transition will depend on a range of factors, an indication of the costs involved in transitioning a global equity mandate, as determined through conversations with investment transition managers, could be in the region of 0.1% – 0.2% of the value of funds transitioned.

- The overall costs of any merger of the existing funds would depend on a number of factors including whether there was any increase in the usage of passive management across the equity and bond portions of the resulting merged fund(s).

- There is no clear evidence to suggest that moving from the current structure to larger funds would result in an improvement in performance.

- With the increasing complexity of investment solutions, we believe that there would be scope for governance benefits by moving from the current structure, particularly in terms of increased levels of professional advice/expertise and the benefits of scale associated with the cost of external advice. These benefits would be most marked for the small and medium sized funds.

- There are considerable complexities to address on the actuarial aspects of any merger of funds in relation to the management of legacy deficits from ceding funds and the setting of an actuarial funding basis to determine future employer contribution rates.

iii Recommendations

- We believe that the potential savings in investment management fees from rationalising the investment management arrangements would not be significant enough to justify, in cost terms alone, moving from the current structure to 1, 2 or 3 funds.

- In addition, as there is no clear evidence that moving from the current structure would result in an improvement in investment performance, we do not recommend that any of the 1, 2 or 3 proposed merged options are progressed.

- Consideration should be given to relaxing the constraints on the proportion of assets that can be invested in a single fund or insurance policy where the underlying investment is being managed on a passive or index tracking basis to allow a higher proportion of assets to be managed passively which would result in lower investment management fees.

- There would be benefits, particularly for some of the small and medium sized schemes, if a shared central resource was established to provide cost effective technical advice and assistance to officers and elected members on some of the more complex investment opportunities and issues and we recommend that further research is carried out to investigate the feasibility of this.

4. Future Administration Options

To develop our recommendations under this workstream we have carried out an options appraisal considering options for the most appropriate administration delivery models. This was based upon costs and service information gathered by the Improvement Service and Deloitte, and supplemented by input from pensions officers at current administering authorities. The options appraisal looks to balance the benefits and risks which are expected to arise from adopting a changed administration delivery model, in order to identify appropriate recommendations.

The options that have been appraised are:

i. Maintenance of current arrangements;
ii. Maintenance of current arrangements with a revised approach to delivering services;
iii. Merger of administration services into one, two or three centres; and
iv. Transferring of pensions administration services to an external provider.

To assist in assessing the range and depth of services provided by the current administering authorities we have developed the concept of “core” and “non-core” administration services. Core services are those administrative requirements which are either required under legislation or form such as integral part of the administration delivery that their performance is deemed essential.

Non-core services are other supplementary services performed by the administering authorities which, whilst providing an enhanced quality or range of services, are not deemed to be essential. The ability to deliver against the core services, and the treatment of the non-core services, has formed an important part of the options appraisal and was agreed among the stakeholder group.

It should be noted that a wider review of police and fire and rescue services in Scotland is being carried out (in terms of overall service delivery model and organisational structure), and that this is expected to influence decisions around how pensions administration for police and fire and rescue is delivered in future.

Our findings and recommendations against each of the options are summarised below.

i. Maintenance of current arrangements

Under this option there would be no change to the status quo of each of the 11 funds providing administration services independently: current services and service levels, as well as administration governance and oversight arrangements, are assumed to continue unchanged.

Findings

- At £20.92 per head, the weighted average pensions administration costs per member (excluding any disclosed actuarial or external audit costs) across the 11 funds in Scotland compares favourably with the average per member cost for all LGPS funds in England and Wales[1] (£28.31).
- Even allowing for higher overhead and salary costs in the London area, and potential variances in the way costs in the Department of Communities and Local Government (DCLG) analysis are calculated compared to the results of the CIPFA Benchmarking Analysis, the average per head administration cost would seem to be lower across the 11 Scottish funds.
- However, our research into the shared service arrangement between Cumbria and Lancashire indicates that there is potential for the full range of LGPS services to be delivered at a cost which is lower than the Scottish (net) weighted average.
- Pensions administration services are broadly comparable across the 11 funds however service levels currently vary.
- Administration governance and oversight arrangements also vary across the 11 funds. Some funds do not have service level agreements in place, report on performance to members or employers, or prepare reports on administration performance to elected member committees.
- There is no direct correlation between fund size and administration cost for the Scottish funds: while the largest fund (Strathclyde) has a lower than average per member cost (£20.50), the next largest fund (Lothian) has the third highest cost (£24.42).
- There are no formal arrangements in place for collaboration and partnership working in the delivery of administration services across the 11 funds, although the Scottish Pensions Liaison Group (SPLG) provides a knowledge sharing platform that could be further developed.
- The customer survey carried out for the Administration Management Workstream Summary Analysis Report indicates that overall employer and member satisfaction levels with services

[1] Department of Communities and Local Government: Local Government Pension Scheme Analysis 2009-2010

provided by the current 11 funds is relatively high – particularly from employers and pensioners; there is a desire however from employers for more electronic communications.

- Some of the funds provide administration services with less than four full time equivalent staff and this creates a potential risk to service delivery should staff be unavailable for prolonged periods or where staff leave unexpectedly.

Recommendations

- We recommend that this option (maintenance of current arrangements unchanged) is not considered further as we believe there are opportunities to reduce costs, improve service levels and improve administration oversight and governance arrangements.

ii. Maintenance of current arrangements with a revised approach to delivering services

Under this option, the current structure of 11 funds would be maintained, but revised approaches to delivering administration services would be implemented. We have identified and considered the following improvements which could be implemented together or separately:

a) standardisation of services and service levels;

b) standardisation of administration governance and oversight arrangements; and

c) single operating model and common administration system.

a) Standardisation of services and service levels

All funds would agree the administration services that should be provided and would agree consistent service delivery levels and monitor performance against these.

Findings

- Standardisation of services and service levels under the 11 fund structure would require consensus on what services to provide, how these are best delivered (for example a common channel strategy), and what levels of service should be provided. This would require a resource commitment from all funds, an agreed timetable for delivery and pro-active management to gain agreement and implement.

- Standardisation of services and service levels, and formalised reporting of actual performance against these levels, would allow for greater transparency in future service delivery and cost as well as opening up the potential for future cost sharing in areas such as communications, training and the procurement of third party services.

- Achieving consensus on services and service levels will also support those funds that choose to comply with the proposed new (optional) legislative requirement[2] to prepare and publish details of their pensions administration strategy by rationalising the compliance process and allowing for greater comparison across funds.

- Given the considerable variance in scale and administration resources between the largest and smallest funds, and the assumption that standardisation of services and service levels would involve "levelling up" to current best practice, we would expect that there would be an increase in costs for those funds whose services or service levels are currently below best practice levels.

[2] The Local Government Pension Scheme Amendment (Scotland) Regulations 2010 (Draft November 2009) – New clause 60A

- Any additional costs of levelling up to best practice standards could be mitigated, in part, by agreement to levy additional charges across the 11 funds to employers and members for non-core additional services.

- Standardisation of services and service levels will also open up opportunities for cost savings in areas such as performance reporting, training and communications.

Recommendations

- Funds should develop and implement standard services and service levels to improve service delivery and consistency.

- Funds should establish which additional non-core services to members and employers should be charged for separately and agree a schedule of costs to be applied by all funds.

- Opportunities for cost savings presented by having standardised services and service levels should be further explored.

b) Standardisation of administration governance and oversight arrangements

All funds would develop and comply with consistent administration governance standards and oversight arrangements.

Findings

- Agreeing common future administration governance and oversight standards and procedures will allow for greater future transparency and consistency in areas such as risk management, performance reporting, service level agreements, discretionary policies and the allocation of central charges by administering authorities to funds.

- We would expect a small increase in ongoing costs if current administration governance and oversight arrangements were levelled up to best practice standards.

- Any increase in costs could be justified in terms of the increased transparency and assurance that it would provide in relation to how future pensions administration is carried out and charged for; this will support ongoing analysis of scheme administration efficiency.

- Standardising administration governance and oversight arrangements would also support draft legislative requirements[3] for all funds to prepare an annual report containing (amongst other things) a report of the arrangements made during the year for the administration of the fund and the requirement to prepare and publish a governance compliance statement.

Recommendations

- We recommend that funds develop and implement standard pensions administration governance and oversight arrangements to achieve greater consistency and transparency in the delivery of pensions administration.

c) Consistent operating model and common administration system

Some funds, and in particular those with high fixed costs, could choose to develop and implement a new consistent operating model which would enable a virtual shared service operation for future pensions administration. This could also enable the future procurement of a single pensions administration system covering all the administration service requirements of those funds.

[3] The Local Government Pension Scheme Amendment (Scotland) Regulations 2010 (Draft November 2009) – New clause 31A

Findings

- Some funds operate with relatively small numbers of staff in locations where it may be difficult to recruit replacement staff.

- For some funds, annual IT costs are over 20% of total administration costs whereas for other funds IT costs are less than 10% of total cost, the lowest being 5.3% of total cost (Strathclyde) and the highest 25.5% (Dumfries and Galloway).

- Developing a consistent pensions administration operating model would enable sharing of resources and spread of workload over different locations. While this would require significant input and resource commitment from the funds that choose to pursue this, we believe it could enable benefits of:

    - mitigation of key man risk identified for smaller funds;
    - reduced IT costs per member;
    - sharing of expected costs for implementing future benefit structure changes; and
    - maintenance of current local levels of employer and member support services.

- The detailed feasibility of this option, and associated implementation and ongoing operating costs, would need further investigation and will be a function of the number of funds that wished to pursue this option.

- The shared operating model should be designed to incorporate the recommendations above on standard services and service levels as well as on standard administration governance and oversight arrangements.

- Any future shared operating model may need to consider how future police, fire and rescue pensions administration services are delivered for those funds that currently provide this service.

- Formal co-operation between the funds that pursue this option should be detailed in a Collaboration Agreement between the funds to allow for collective procurement and clear definitions of ways of future working.

Recommendations

- We recommend that funds are asked to consider this option and, subject to levels of interest, a feasibility study, including costs, resource requirements and implementation plan is carried out that funds can sign up to.

iii. Merger of administration services into one, two or three centres

Under this option, pensions administration services would be provided from 1, 2 or 3 administration centres in line with the fund merger options that have been identified under the Investment Management Workstream.

Findings

- Criteria identified for determining potential host authorities include:

    – expected future cost per member;

- size of current administration operations;
- ability and willingness to scale up;
- range and quality of services; and
- location and availability of resources.

- Future costs under this option will be a function of the new operating models developed by host authorities to provide both their existing services plus the services for ceding authorities.

- For illustrative purposes only, applying the current per member costs of the largest and lowest cost administration centres under each of the three merger options, produces the following cost savings/(increases) when compared against current costs:

Merger Option	Largest fund as host Annual Saving/(Increase)	Lowest cost fund as host Annual Saving/(Increase)
1 Fund	Strathclyde Annual saving = £196k	Falkirk Annual saving = £2.65m
2 Funds	Strathclyde (West) Lothian (East) Annual increase = (£854k)	Dumfries & Galloway (West) Falkirk (East) Annual saving = £2.22m
3 Funds	Strathclyde (West) Lothian (East) North East (North) Annual saving = £106k	Dumfries & Galloway (West) Falkirk (East) Highland (North) Annual saving = £2.02m

- Applying the lowest current per member costs under the ‘1 Fund’ option produces the greatest potential annual savings at £2.22m pa however clearly there would be considerable scalability and other issues to address and we are not recommending this option.

- Taking Strathclyde as an example of a large scale administration centre delivering administration services at lower than the overall average weighted costs per member, and applying its current costs across each of the three merger options, would result in an annual saving under each of the three merger options of only £196k pa.

- The increase in costs noted under the ‘2 Funds’ options using largest fund as host primarily arises as a result of applying the current higher than average costs per member reported for the Lothian Pensions find to the ceding funds in the East group.

- Research on the arrangements between Cumbria and Lancashire shows that fully comprehensive LGPS administration services can be provided from one fund’s administration centre to another fund’s members at a lower cost than the current weighted average for the Scottish funds and this indicates that there is the potential for cost savings as well as successful implementation of shared service arrangements for LGPS pensions administration in Scotland.

- Implementation of any of these merger options would require significant investment, both in terms of the cost of developing the required new operating models and from resources in ceding and host authorities to effect the transition of data and knowledge of employers and discretionary practices.

- Merger of the current 11 administration centres could result in a loss of face to face local employer and member support services, although designated host authorities would be expected to address this when developing their service offering**.**

- Standardised services, service levels, administration governance and oversight arrangements as noted under (option ii) above could be incorporated into new host authority operating models. A merged model should enable simpler implementation of any new administration requirements arising out of potential future benefit structure changes.

- There would however be significant transition risks to address on data transfer, new process design and the establishment of links between new host authorities and all the current employers under the ceding authorities.

- Previously identified "key man" risks for smaller funds would be mitigated under this option.

- We have not established any clear evidence that there are economies of scale to be achieved through the scaling up of LGPS administration services. For example, administration cost data from LGPS in England and Wales[4] indicates that there is little variation between funds in administration costs per member once a fund size of £1bn is achieved. However, it should be noted that the largest LGPS fund in England and Wales (Greater Manchester) reports annual administration costs of £14.77 per member.

Recommendations

- A lack of consensus on potential host authorities, the cost and commitment required to develop new operating models to accommodate ceding funds, combined with uncertainty on future possible cost savings, leads us to the view that merger into 1, 2 or 3 funds for the future pensions administration is not likely to deliver significant benefits or indeed be possible to implement successfully. We recommend that the three merger options identified for future administration are not taken forward.

- However, small fund administration mergers and shared service arrangements similar to those in place between Cumbria and Lancashire should be investigated further, with active support from host and ceding funds. This would mitigate the key man risk identified for the four smallest funds and avoid the additional cost for ceding funds of levelling up to best practice service and governance standards as well as the implementation costs of future benefit structure changes.

iv. Transferring of pensions administration services to an external provider

We have considered two alternatives under this option:

a) transferring to the SPPA; and

b) outsourcing to a private sector provider.

a) Transferring to the SPPA

[4] Communities and Local Government: Local Government Pension Scheme Analysis: 2009-2010

Under this option, all administration services for the LGPS in Scotland would be taken over by the Scottish Public Pensions Agency (SPPA) under a 'Public-Public' partnership arrangement. The SPPA currently provides pensions administration services for the NHS and Teachers' Pension Schemes in Scotland covering over 450,000 members. SPPA also provides legislative services for the LGPS in Scotland on behalf of Scottish Ministers.

Findings

- As part of Phase 1 of the Pensions Pathfinder Project, SPPA was identified as a potential provider of future pensions administration services for the LGPS in Scotland as its per member pensions administration charge for the Teachers' and NHS Schemes (£12.99 per head) indicated that annual savings of £3.25m could be achieved compared to current LGPS administration costs.

- However, the Phase 1 report noted that there was a difference in the nature of the service provided by the SPPA for the NHS and Teachers' Schemes and that currently provided by administering authorities for the LGPS.

- We have prepared a detailed schedule of LGPS administration services based on current legislative requirements as well as current operational practice, in order to ensure that the appraisal of SPPA can be considered on a like for like basis. All funds have been asked to input to this schedule and requested revisions have been incorporated.

- This schedule of services has now been passed to SPPA with a request for a response on their ability to deliver these services. Subject to this response, SPPA will be provided with details on current administration activity levels and will be asked to provide details on costs and service levels for further consideration.

- Any transfer of services to SPPA would involve establishing a significant transformation programme to manage the process and there are transitional risks relating to database transfer, establishment of links to employers, loss of local support / staff knowledge and potential risks to business as usual operations which need to be factored in, as well as staff transfer and potential redundancy costs.

- We have noted during our research that there was little appetite for this option among the stakeholder group, therefore achieving buy in and successful implementation are likely to be difficult to secure.

- SPPA currently has a role in relation to the LGPS in Scotland as the body responsible for drafting regulations on behalf of Scottish Ministers; any future role for SPPA as an administration provider would need to be structured to ensure that potential conflicts of interest are mitigated.

- Any formal agreement setting out the terms on which SPPA would provide administration services will need to be structured to avoid a potential challenge from private sector providers that a contract has been let and specialist legal input will be required.

Recommendation

- We recommend that the option of transferring administration services to SPPA is considered further once SPPA responds to the recent request and provides confirmation on their ability to provide the services on the schedule and the likely costs of this. However it must be recognised that, given the lack of appetite for this option among the stakeholder group, even if savings are identified this may not be a plausible option for implementation due to the low chance of success and resulting risk to the business.

b) Outsourcing to a private sector provider

Under this option, all administration services for the LGPS in Scotland would be outsourced to a private sector pensions administration provider.

Findings

- The Phase 1 report estimated that potential savings of £2m pa could be achieved by outsourcing pensions administration for all 11 funds to a single administration centre run by Xafinity Paymaster at an indicative cost of £17.85 per head.
- Applying this indicative cost to the current membership profile and comparing it against current net administration costs shows that potential savings of £1.45m pa could be achieved. However as noted in the Phase 1 report, the service package provided by Xafinity Paymaster differs from that currently provided by the LGPS funds so is not a fair comparison.
- Cumbria County Council recently considered whether to outsource future pensions administration to Capita (their provider prior to 1 Feb 2011) and concluded that costs were higher than their chosen option (entering into a Collaboration Agreement with Lancashire County Council), and service levels were lower.
- An independent survey of pensions administration costs commissioned by Capita in 2010 covering over 400 schemes (including public sector schemes) showed an average cost for third party providers of £41 per member for the largest scheme size category (over 10,000 members).
- We would expect, however, that competitive tendering for outsourcing LGPS administration in Scotland would result in a significantly lower cost than £41 per member although it should be noted that the cost can only be established with any certainty by carrying out a market testing exercise.
- Outsourcing services to a private sector provider for all 11 funds would incur similar risks, and potentially higher implementation/procurement costs, as transfer to SPPA however at this stage the potential savings do not appear to be as significant .
- Unsurprisingly, the same issue on lack of appetite among stakeholders for this option exists as for outsourcing to SPPA with the associated risks this entails,

Recommendation

- Given uncertainty over ongoing costs, services and service levels and the fact that based on the data available a transfer to SPPA could potentially deliver higher savings, we recommend that transferring to a private sector provider is not taken forward.

5. Governance

In order to address the specific questions relating to future governance arrangements, we have carried out research on current and potential future governance arrangements for the LGPS under the alternative options that have been set out for appraisal.

Findings

As requested, our research on future governance options at this stage of the project has been focussed on what is achievable under the current legal framework of pensions committees appointed by administering authorities. A legal query was raised during our research as to whether membership of pensions committees could be expanded to include non elected voting members. We have raised this with SPPA who have confirmed that councils have the ability, under current legislation, to broaden membership of committees to include non-elected members at their discretion. We note however, that Lothian Pension Fund has received internal legal advice which contradicts this.

Currently, elected members are appointed to pensions committees at the discretion of the administering authority following local government elections, and broadly reflect the political balance of the administering authority.

Regulations, supported by recent guidance[5] from Scottish Ministers, require that each fund publishes a governance compliance statement including details of committees, their membership and the frequency of meetings.

The terms of reference of the pensions committees are set separately by each authority and our research indicates that terms of reference vary across the 11 funds. In addition, the supporting structures that sit under the main pensions committees (advisory committees and other panels and forums) also vary.

We believe that there is an opportunity for greater consistency in the terms of reference of pensions committees across the 11 funds to incorporate best practice indicators in pensions fund governance. This would provide more clarity to all stakeholders on the role and responsibilities of all pension fund committees and will strengthen overall governance arrangements.

The merger of the current 11 funds into up to three future funds would result in a further concentration of the current position which sees 11 funds acting for 32 unitary authorities. This is a legacy of regional government arrangements from 1975 which were not reversed on the abolition of regional councils in 1996. We believe that this raises questions on whether, under any future merger, the current structure allows for sufficient representation of employers and members interests on decision making committees.

Recommendations

- Model terms of reference for LGPS pensions committees in Scotland should be developed which clearly and consistently define the role and responsibilities of pensions committees, referencing current pensions governance best practice where appropriate and building on existing governance compliance guidance; wider stakeholder consultation should be carried out in developing the model terms of reference.
- Once developed, the terms of reference should be adopted and implemented by all pensions committees and consideration should be given to regulatory guidance on implementation.
- Membership of pensions committees should be extended to include representatives of other employers, member representation and external professional representation; this will be particularly relevant if any funds are merged.
- The feasibility of a shared specialist investment advisory resource comprising a panel of investment professionals and fund officers to provide smaller and medium sized funds with cost effective advice on complex investment issues should be further investigated.

[5] Local Government Pension Schemes in Scotland Governance Compliance Statements Guidance: November 2010

6. Overall conclusions

Fund mergers

Based on the evidence currently available and the research and analysis we have carried out, we do not recommend that the options identified for merger of the current 11 funds into 1,2 or 3 future funds based broadly on geographical location are progressed. This is as a result of:

- The absence of a clear business case that merging funds will deliver either material savings in future investment management fees or will, of itself, result in an improvement in future investment performance
- Expected cost savings from merger of administration services are uncertain, and are at best marginal, and do not justify incurring the costs and risks that would be incurred in achieving merger
- There is a lack of clarity on which of the current funds would be willing and able to act as future host authorities under the merger options identified
- There is a general lack of appetite among funds to progress any of the merger options which leads to a risk of achieving successful implementation

Improvements to current arrangements

There are however a number of improvements to the current arrangements that we have identified and we recommend that these are progressed under the next phase of this project. These are:

- Development of a model Terms of Reference for the constitution of pensions committees under each of the 11 funds to clearly define their role and responsibilities
- Widening the membership of pensions committees to improve overall accountability and transparency
- Research into the feasibility of a shared specialist investment advisory resource to provide smaller and medium sized funds with cost effective advice on complex investment issues
- Research into the feasibility of a shared operating model and administration system for funds that have either high fixed administration costs and/or where a “key man” risk has been identified
- Development of standard services and service levels across the 11 funds, based on current best practice and consideration as to what non-core services could be subject to additional charges to members or employers
- Development of standard administration governance and oversight arrangements across the 11 funds, based on current best practice
- Subject to incorporation of improvements as noted above, further consideration could be given to a potential transfer of administration services to SPPA subject to clarification on service delivery and cost

Many of these recommendations are consistent with the recommendations set out in the final report of the Independent Public Service Pensions Commission and will require active support from each of the administering authorities. The method statement for the next phase of work under this project will set out further detail on activities and deliverables.

1 Investment Management - Initial Research

This section summarises the Investment Management initial research and considers the implications of the three alternative models outlined in Section 1.2 relative to retaining the status quo of 11 separate funds.

1.1 Methodology

This review has been carried out drawing together information obtained from each of the 11 funds and broader market information.

We have been provided with investment data in the form of the LFR24 analyses for the CIPFA (Scotland) Pensions Sub Group. Additional information and data has been provided by the administering authorities and we have conducted interviews with officers at each of the administering authorities. Summary notes from the interviews with each of the authorities are included in Appendix 2. We note that the investment data provided in the LFR24 analyses is heavily caveated with a number of qualifications on the limitations of the data and consistency of the information between authorities, particularly in relation to costs – see Appendix 3.

To assist in investment manager fee analysis, we have sourced indicative fee quotes from a range of investment management organisations (including all the investment managers that provided investment management services to the 11 funds) for different mandate sizes and covering the traditional asset classes (i.e. UK and global equities and UK bonds).

1.2 Overview

As at 31 March 2010 there was approximately £22bn of pension scheme assets held across the 11 LGPS funds in Scotland, investing in a broad spectrum of assets covering UK and overseas equities, UK and overseas bonds, cash and "alternative investments". The range of alternative investments includes property (both UK and global), private equity, infrastructure and active currency funds. Exposure to the various assets has been obtained through a combination of segregated portfolios (where the assets are held in distinct portfolios, registered in the name of the specific scheme) and pooled funds (i.e. investing alongside other investors in a fund), using both internal and external investment management expertise. The investment management costs incurred by the funds amounted to approximately £50m for the year ending 31 March 2010.

The value, range of investments and number of investment managers for the 11 funds are summarised below including the proportion of each fund which is passively managed. Across the 11 funds, there were 37 different investment management organisations providing services under 85 different mandates as at 31 March 2010.

Table 2.1 – Summary of the 11 LGPS funds

Fund	Aberdeen	Dumfries & Galloway	Falkirk	Fife	Highland	Lothian	Orkney	Scottish Borders	Shetland	Strathclyde	Tayside
Assets at 31 March 2010 (£m)	2,034	472	1,073	1,174	887	3,538	138	339	221	10,307	1,749
Strategic Benchmark (%)											
Equity	77	63	70	70	75	66	71	75	83	68	70
Bonds	8	25	15	20	15	5	19	18	9	15	18
Property	10	10	10	10	10	12	-	7	7	12	12
Alternative	5	2	5	-	-	15	10	-	1	5	-
Cash	-	-	-	-	-	2	-	-	-	-	-
Number of Managers	7	6	7	7	5		1	2	3	17	6
% Passively Managed	30%	27%	0%	20%	20%	21%	0%	13%	92%	35%	0%

1.3 Drivers for rationalisation

We believe the three key potential drivers behind the rationalisation from the current structure to 1, 2 or 3 larger funds are:

- Lower costs – both in terms of a reduction in the resource required to run the resulting portfolios versus keeping the schemes separate, but also, more significantly, in terms of the potential benefits of scale from fee savings covering investment management, custody and safe keeping and other services;
- Improved performance – working on the basis that with larger pots of assets, the range of investment opportunities available to the scheme could potentially broaden and provide a benefit in terms of either improved or more consistent performance;
- Better investment governance – working on the premise that with the economies of scale, the resulting schemes could afford/justify increased expenditure on external services and advice to facilitate/improve the governance of the schemes and the underlying assets.

In the following sections we look at each of these in more detail.

1.4 Lower costs

The main costs from an investment perspective associated with running a pension scheme include:

- The cost of the in-house personnel required to assist the trustees or committee with the governance of the scheme and to facilitate the day to day management of the investment arrangements;
- The investment management fees;
- Custody and safe keeping costs; and
- Additional external services such as independent advice, consultancy services, performance measurement.

The most significant of these costs is the investment management fees, where the fees paid will depend on the underlying asset classes covered, the performance objectives of the specific mandate and the value of assets. Typically we would expect the investment management fees to account for around 80 – 90% of the total costs – although this will depend on the extent to which passive management or index tracking managers are used, where the associated investment management fees are lower.

In examining the costs and whether there are potential savings from moving from the current arrangements to one of the three alternative models being proposed, we have used the information provided by the funds in the LFR 24 analyses. In a number of cases, further information and detail has been provided by the respective administering authorities.

While the LFR24 analyses provide information covering the benefits and investment administration and investment management costs, specific detail of the investment manager fee scales applied to the mandates by the underlying investment managers and details of performance fees where in place, have not been provided due to commercial confidentiality concerns.

To provide an indication of the level of investment management costs being paid by each fund the tables overleaf show the investment management costs as stated in the LFR24 analyses for each of the last 6 years to 31 March, first in absolute terms and then as a proportion of the value of the fund assets each year (1 basis point is 0.01%).

Table 2.2 – Investment management costs as reported

Investment Management Costs (£)						
Year Ending 31 March	2005	2006	2007	2008	2009	2010
Aberdeen	2,477,174	3,205,462	5,181,319	5,020,475	3,987,989	4,323,893
Dumfries & Galloway	763,379	717,372	418,677	1,172,749	1,409,724	1,199,179
Falkirk	1,985,358	2,129,906	3,367,620	4,121,878	4,268,697	3,609,996
Fife	2,316,085	2,593,112	3,202,365	5,285,716	4,669,605	5,617,376
Highland	1,434,946	1,568,073	2,101,295	2,290,154	1,908,701	2,448,007
Lothian	5,747,421	7,467,079	10,328,921	11,545,778	12,160,962	10,968,946
Orkney	209,000	363,000	256,000	330,000	322,000	323,000
Scottish Borders	567,973	812,838	894,259	919,484	844,362	996,146
Shetland	670,829	768,486	833,110	1,036,755	714,686	262,228
Strathclyde	9,058,113	14,864,681	14,150,019	19,496,159	16,977,769	12,942,754
Tayside	3,289,122	4,408,341	5,317,920	5,383,311	4,121,866	6,301,992
Total	**28,519,401**	**38,898,350**	**46,051,504**	**56,602,459**	**51,386,360**	**48,993,517**

Table 2.3 – Investment management costs as percent of asset value (basis points)

Investment Management Costs (Basis Points)						
Year Ending 31 March	2005	2006	2007	2008	2009	2010
Aberdeen	20	21	29	28	25	25
Dumfries & Galloway	25	19	10	26	36	29
Falkirk	30	27	37	43	49	39
Fife	32	29	31	49	49	56
Highland	26	24	27	28	27	32
Lothian	27	28	33	35	42	36
Orkney	32	43	26	31	32	28
Scottish Borders	27	32	30	31	58	35
Shetland	48	46	42	52	42	14
Strathclyde	14	18	15	20	35	14
Tayside	31	33	34	33	29	45
Total	**21**	**23**	**23**	**28**	**36**	**25**

1.4.1 Investment management fees

In most cases we would expect the investment management fee scales to be on a sliding scale such that the total fee as a percentage of assets decreases as the size of the mandate increases (the exception to this would be where a performance fee structure is in place). With this in mind, we would therefore expect to see some savings at the collective level if assets are combined into one of the proposed models. The extent to which you would see savings though will depend on the extent to which the existing mandates could be merged or combined without having an adverse impact on the investment manager's ability to achieve the targeted level of outperformance. Where passive mandates are involved, this issue would not apply.

Where we would expect to see the least saving would be for the portfolio comprising the Strathclyde fund if either the 2 or 3 fund models were adopted – the reason being that there is minimal overlap across the existing mandates and the Dumfries and Galloway assets would amount to less than 4% of the total enlarged portfolio.

Based on the information we have been provided by the 11 administering authorities, it has not been possible to determine the extent to which there would be investment management fee savings moving from the current situation to any of the proposed models.

To assist with the analysis we have contacted a range of investment management organisations (including all the investment managers that provided investment management services to the eleven schemes) to obtain indicative quotes for different mandate sizes covering the traditional asset classes (i.e. UK and global equities and UK bonds). This has provided us with indicative current fees for different mandates covering both active and passive mandates. For the active mandates, the fees are based on the assumption that the mandates are core in terms of their respective performance targets (i.e. +1% net of fees for UK equities, +2% net of fees for global equities and 0.5% net of fees for bonds).

In using this information, we recognise that there is the option for using performance related fees where the base fee payable is lower and a performance element is payable if performance is above the agreed benchmark. We have not allowed for this in this analysis, on the grounds of the wide variety of performance fee structures offered by investment managers and the relatively low level of take up of performance related structures within the context of mandates covering the traditional asset classes. Our analysis on the investment management fees is restricted to the traditional asset classes of equities and bonds, albeit recognising that approximately 17% of the total assets across the 11 funds was invested in non traditional asset classes such as property, currency and alternative investments as at 31 March 2010.

The tables below outline the average indicative management fees obtained from our survey of investment managers for UK and global equities and UK bonds for different mandate sizes.

Table 2.4 - Indicative Active Management Fees (basis points)

	UK equities			Global equities			UK bonds		
	£300m	£500m	£750m	£300m	£500m	£750m	£300m	£500m	£750m
Average	39.6	36.7	34.9	42.6	39.7	37.6	21.7	19.7	18.1
Number of managers in survey	14	14	14	18	18	18	19	19	19

Table 2.5 - Indicative Passive Management Fees (basis points)

	UK equities			Global equities			UK bonds		
	£1bn	£2bn	£3bn	£1bn	£2bn	£3bn	£1bn	£2bn	£3bn
Average	3.5	3.2	3.0	4.7	4.2	3.7	3.6	3.2	2.7

Using the information from the survey, we have calculated an estimate for the investment manager fees for each of the 11 funds for just the traditional assets. We show these estimates alongside the actual reported fees for the year to 31 March 2010 in the table overleaf.

The reason for focusing on the traditional asset classes of equities and bonds is because of the wide spread of options (and fee scales and structures) covered by alternative investments. In taking this step, we recognise that the fees for alternative investment mandates (particularly private equity and hedge funds) are significantly higher (often with a base fee of 1% - 2% per annum) with performance fees payable over above the base fee. In some instances the fees payable on the alternative investment element could be almost as much as the fees paid on the rest of the portfolio put together, even though it accounts for only a small percentage of the total assets. Based on the information provided it is not clear to what extent the fees for alternative investment mandates have been included within the actual totals reported by the funds.

Table 2.6 – Estimate of fees for traditional assets (for 12 months to 31 March 2010)

	Reported Total Cost £000s	Estimated Cost for traditional assets £000s	% of total assets included in estimate	% of total assets managed on performance related fee
Aberdeen	4,324	4,430	85	48
Dumfries & Galloway	1,199	1,040	88	20
Falkirk	3,610	2,688	85	5
Fife	5,617	2,948	90	25
Highland	2,448	2,307	90	0
Lothian	10,969	6,549	71	n/a*
Orkney	323	462	90	100
Scottish Borders	996	824	93	0
Shetland	262	96	92	0
Strathclyde	12,943	18,473	84	0
Tayside	6,302	5,330	88	27
Total	**48,994**	**45,145**		

* not clear from information provided.

Note: May not sum due to rounding

Reviewing the analysis there are a number of reasons why there will be differences – other than the fact that the estimates do not cover 100% of the assets – which includes the use of performance related fee structures where a lower base fee is charged and the fact that the funds will have negotiated lower fee rates with managers.

It is worth noting that 59 of the mandates across the 11 funds have been in place for at least 5 years, with 24 of the mandates being at least 10 years old. From experience, as well as anecdotal evidence, we are aware that the fees being paid for some of these longer standing mandates are lower than would be charged for a current equivalent mandate. We are also aware that there are fee scales in place where the fund was able to negotiate extremely competitive rates as a result of being an early supporter of the investment manager or a particular strategy.

Taking the above analysis a stage further we have combined the assets and recalculated the fees for each of the proposed models. The analysis below shows the resulting asset mix for the three models being considered, assuming the assets are combined without any strategic reviews being undertaken.

Table 2.7 – Resulting asset mix and estimates of investment management fees for the 3 alternative models

	Model 1	Model 2		Model 3		
Year Ending 31 March 2010	Fund	Fund A	Fund B	Fund A	Fund B	Fund C
Aggregate Assets (£000's)	21,932,366	10,779,216	11,153,150	10,779,216	6,123,861	5,029,289
Aggregate Strategy						
Passive	27%	35%	20%	35%	20%	20%
Active UK Equity	8%	2%	14%	2%	15%	12%
Active Overseas Equity	38%	38%	37%	38%	33%	43%
Active Bonds	10%	8%	11%	8%	10%	13%
Property	11%	12%	11%	12%	11%	10%
Alternative	6%	5%	6%	5%	10%	2%
Cash	0%	0%	1%	0%	1%	0%
Indicative Estimated Fees (£000's)						
Aggregate Fees for traditional assets	43,420	19,385	24,233	19,385	12,539	12,019
Total	43,420	43,619		43,944		

This analysis assumes that there would be no change to the overall mix of assets or the split between active and passive management as a result of any merger.

The analysis suggests that there would be scope for some savings in investment management fees moving from the current structure of 11 separate funds, with the largest estimated saving being achieved by moving to a single fund, albeit the savings are not significant in the overall context. We note that there is not that much of a difference between the estimated fees payable for traditional assets under Models 1 and 2.

Table 2.8 – Summary of estimated investment management costs for traditional assets

Year ending 31 March 2010	Current	Model 1	Model 2	Model 3
Estimated fees	£45.145m	£43.420m	£43.619m	£43.944m

1.4.2 Other external fees and costs

In addition to investment management and custody, the 11 funds currently subscribe to a range of other services covering performance measurement, voting and the provision of independent advice encompassing both investment consultancy and, in a limited number of cases, independent trustees.

We received information from some administering authorities on their expenditure covering these areas which highlighted that the additional costs of investment advisors and their services have amounted to less than 1 basis point (0.01%) of the value of assets when averaged over the last 3 years.

Relative to pension schemes in the private sector, our experience suggests that the average expenditure by local government funds on investment advice is lower. This is borne out from the interviews with the pensions officers, where the majority of funds will tend to use investment consultants more for specific projects than to provide ongoing assistance and advice.

Unlike some of the other costs, the relationship between the cost of advice and the size of the fund is not a linear relationship and one where we would expect there to be some clear economies of scale benefits. However, overall we would not expect the costs to exceed much more than a couple of basis points (averaged out over a number of years), with the type of advice changing depending on the complexity of the underlying arrangements and the extent and quality of the in-house resource.

1.4.3 Staffing

Table 2.9 – Investment staff* (as at 31 March 2010)

	Aberdeen	Dumfries & Galloway	Falkirk	Fife	Highland	Lothian	Orkney	Scottish Borders	Shetland	Strathclyde	Tayside
Investment Administration	3	1	1	1	1	8	0	1	1	1	2
Investment Management	-	-	-	-	-	7	-	-	-	2	-

* Full time equivalent

From the discussions with representatives of the administering authorities it would appear that there would be little impact on staffing levels for authorities if the investment management of the funds were transferred to one of the alternative models. The exception to this would be Lothian where an in-house team has been built up to manage equity and index-linked gilt mandates on either a passive or enhanced index basis. This team also manages some of the allocation to an alternative assets portfolio where the investment is in specific funds or limited partnerships and not through a fund of funds.

In most cases, personnel with responsibility for investment issues have other roles and responsibilities with some of these also involved with the management of non pension scheme assets.

On the flip side, if the models being considered were implemented using one or more of the existing host authorities it is likely that additional resources would be required – at least on an interim basis to manage the increased number of investment managers and mandates.

1.4.4 Custody

Across the 11 funds there are five different custodians used. Custody fees will typically comprise a combination of an asset based fee, covering general custody and safekeeping, and a transaction charge with additional charges then levied for any additional "value added" services provided by the custodian. In a number of cases the funds have been able to offset at least a proportion of their custody costs through operating a stock lending programme. The information provided suggests that custody costs are in the region of 2 – 3 basis points of the value of assets.

In the broader scheme of things, while there would be operational efficiencies and benefits from merging, the fee savings are unlikely to be significant relative to the investment management costs. If there is a requirement to transition a number of mandates, it is likely that the custody costs would increase, reflecting the turnover required.

1.4.5 Costs of any merger/rationalisation

To this point, we have only considered the potential for cost savings from moving from the current structure. If there is a move to one of the proposed models, it is likely that some rationalisation of investment mandates would be required. The cost of any transition will depend on a range of factors relating to the nature of the actual mandates, the prevailing market conditions and the value of assets being transferred. However, as an indication, the costs of transitioning a global equity mandate could be in the region of 0.1%-0.2% of the assets being transferred, with the costs for a UK equity mandate likely to be slightly higher because of stamp duty payable on purchases.

Given the illiquid nature of the assets, there would be limited benefit from any rationalisation of either the property or alternative investments, although some could be achieved over time, as and when opportunities arose.

A point to note with regard to the issue of rationalisation costs is that with the liability profile of the underlying schemes likely to be maturing faster, any major changes to the investment manager arrangements could be deferred and implemented as part of any broader strategic review.

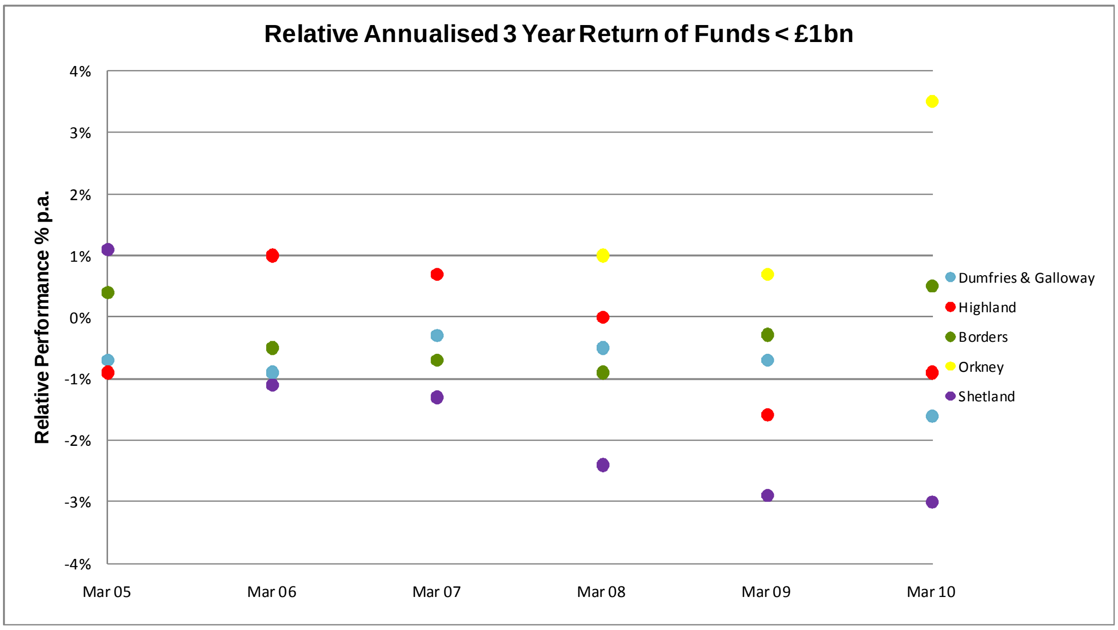
1.5 Improved performance

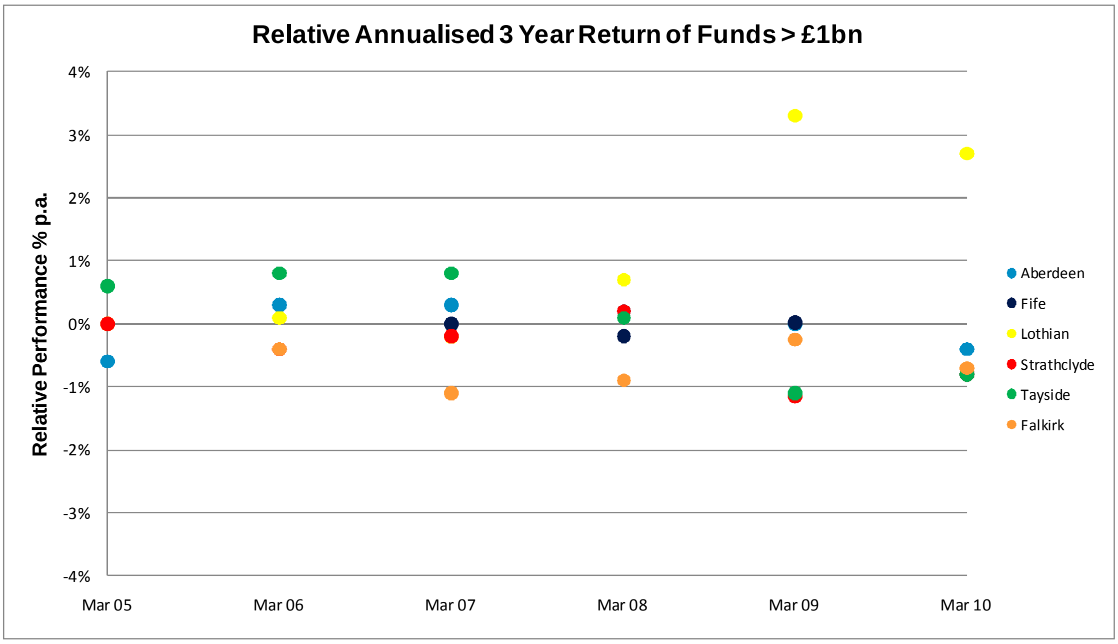
A further argument in favour of moving from the existing structure to any of the proposed models would be if one of the consequences was an improvement in the overall performance. Putting this into context, if merging the assets into larger pots could improve performance by 0.1% per annum the "benefits" to the combined schemes would be in the region of £20m per annum.

Across the pension fund universe there is no hard and fast evidence to suggest that larger schemes perform better than their smaller brethren. This was confirmed in a report by the Audit Commission[6] 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."

To check whether this is the case for the 11 funds, we have looked at rolling 3 year relative returns. For ease of comparison, performance is shown in the following charts, split between funds below £1bn and funds in excess of £1bn as at 31 March 2010.



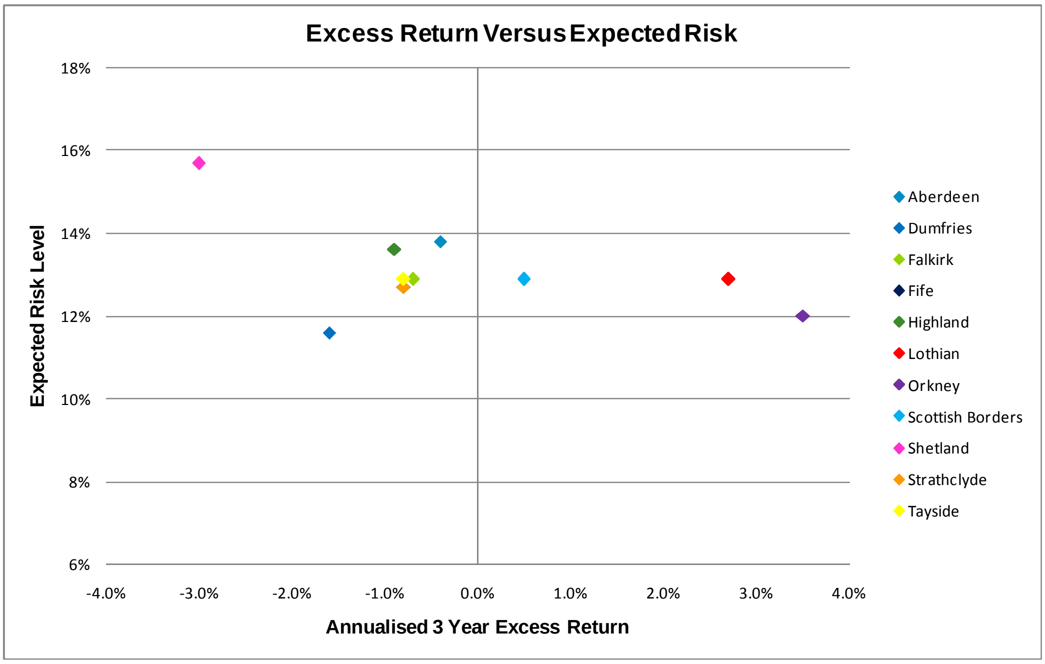


[6] Local government pensions in England – Technical appendices to the Audit Commission information paper, July 2010

Higher investment returns are expected to be generated from portfolios which take higher levels of investment risk. To check whether the performance of the individual funds is being influenced by the level of investment risk being taken, below we look at the risk associated with the schemes' investment strategies. For the purposes of this analysis we have calculated the risk (as defined by the variability of returns) relative to an assumed liability profile of 90% inflation linked liabilities and 10% of liabilities linked to nominal interest rates. We have assumed a weighted average term for the liabilities of 20 years.

	Aberdeen	Dumfries & Galloway	Falkirk	Fife	Highland	Lothian	Orkney	Scottish Borders	Shetland	Strathclyde	Tayside
Excess Return (p.a)[1]	-0.4%	-1.6%	-0.7%	-0.8%	-0.9%	2.7%	3.5%	0.5%	-3.0%	-0.8%	-0.8%
Expected Risk Level	13.8%	11.6%	12.9%	12.7%	13.6%	12.9%	12.0%	12.9%	15.7%	12.7%	12.9%

[1] Annualised 3 year relative return to 31 March 2010



Looking at things from a risk and return perspective, the analysis suggests that there is no clear performance advantage in favour of the larger schemes and if anything, the performance of some of the smaller schemes has been more consistent.

This analysis raises the issue of the benefits of active management.

Taking the rolling three year period to 31 March 2010 and aggregating the relative returns across the 11 funds, we estimate that the funds in total delivered a return that was 0.2% below the composite benchmark. Based on the data provided it has not been possible to determine the extent to which the underperformance was due to:

- Underperformance within the traditional assets portion of the funds;
- A performance drag from the growing allocation to alternative investments; or
- The actual mix of assets being out of line with the funds' strategic benchmarks.

Nevertheless, based on information provided, the aggregate fee across the 11 funds was in the region of 0.22% for the year ending 31 March 2010. We believe it would be possible to reduce costs through the use of passive management for the traditional assets, representing a further benefit. Our survey results indicate that the fee for passive management for traditional assets would be around 0.03%-0.05% per annum.

While not directly covered by the remit of this exercise, broader consideration would need to be given to the implications for the broader Scottish economy if the feasibility of any rationalisation was based around moving the management of the traditional assets to a passive approach (passive management is not really feasible for the majority of alternative asset classes). Currently 25% of the equity assets across the 11 funds are managed by investment management organisations either based in or with significant resource located in Scotland and, at present, there are no passive management capabilities offered to institutional investors by investment managers based in Scotland.

1.6 Better investment governance

Governance arrangements across the 11 funds vary with the larger schemes tending to make greater use of independent advice, delegating elements of the monitoring and implementation of decisions to sub committees (information summarising the formal governance arrangements is included in Appendix 1).

Overall, key to the success of the day to day management of the schemes are the in-house officers where, for a number of the funds, the role is not full time and split across a number of individuals.

1.6.1 Risks

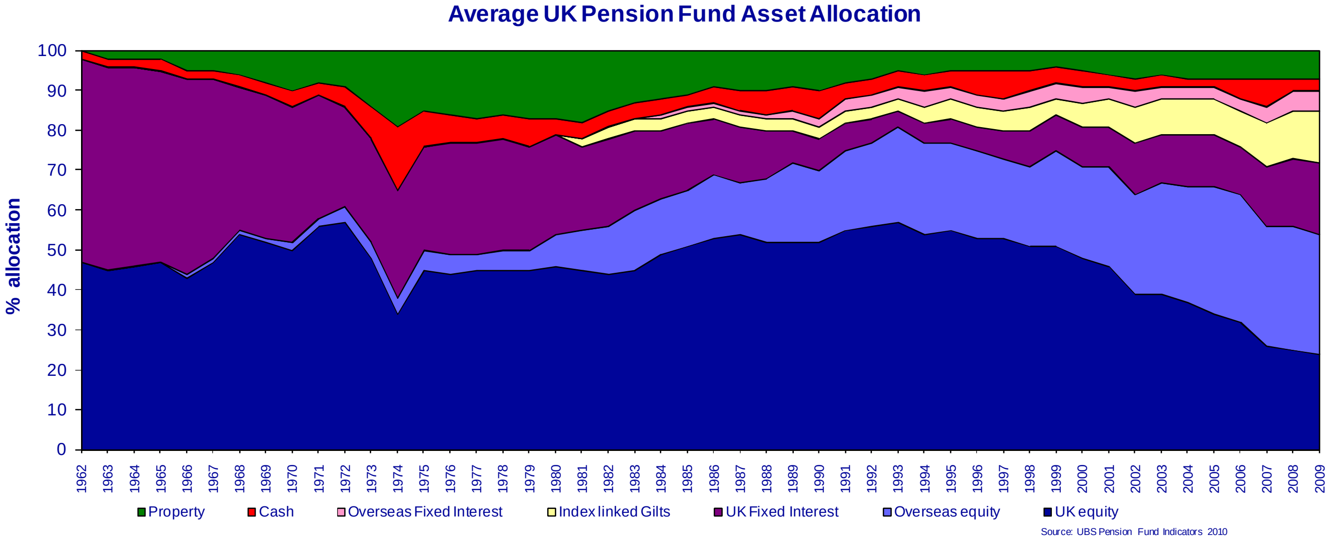
From our discussions with representatives of each of the administering authorities we believe that there are a number of risks associated with the current structure:

- Key man risk – in a number of cases, the knowledge and expertise resides with one or two individuals.
- Generational issues – aligned to the key man risk, we have recently seen a situation with one authority where all the key in-house personnel left the council within a short period of time.
- With a number of funds introducing or increasing their allocation to alternative investments, we have been surprised at the apparent (i.e. based on the reported level of fees paid) lack of external advice being taken in respect of investments that will significantly increase the underlying fees paid.
- Stability of membership of the pensions committees – membership of the committees is determined by the outcome from Local Government elections which has resulted in a lack of continuity making implementation of more complex areas difficult.

1.6.2 Increasing governance requirements

The chart overleaf shows the average asset allocation of private sector pension schemes in the UK and how the average allocation has changed over time. Relative to the trend within the private sector to reduce the allocation in return seeking assets such as equities and property, the 11 LGPS funds in Scotland have retained a far higher allocation to return seeking assets, with an increasing allocation to non traditional or alternative investments.

With public sector cutbacks, there is an expectation that public sector schemes will see deferred and pensioner members beginning to account for a higher percentage of the scheme liabilities. This suggests that consideration will need to be given to de-risking strategies i.e. reducing the allocation to return seeking assets and increasing the allocation to less risky bond type investments. Such strategic considerations are likely to increase the funds' governance requirements.



1.7 Summary and Recommendations

- We would expect there to be savings in investment management fees on moving from the current structure to 1, 2 or 3 larger funds. However, based on the fee analysis we have undertaken to compare the potential investment manager fees under each of the merger models we do not believe that any potential savings would be significant. Our analysis suggests the savings would be less than 1 basis point of the total value of assets, namely, less than £2m pa across all funds.
- While merger of some individual funds would result in a reduction in the current level of investment management fees, it is likely that in other cases there would actually be an increase given the increased complexity of the investment arrangements of some of the larger funds where these larger funds become future host authorities. Whilst the expectation is for improved returns from this increased complexity, we do not have evidence to support the assertion that increased complexity leads to higher returns.
- While we do not have the details of individual mandate fee structures we have been informed that across the 11 administering authorities there are a number of investment mandates that are being operated on competitive investment management fees, in particular where mandates have been in place for over 10 years.
- Offsetting any potential savings from lower investment management fees, are the costs that would be incurred moving from the current structure and reducing the overall number of investment managers and mandates to more manageable levels. Whilst the cost of any transition will depend on a range of factors an indication of the costs involved in transitioning a global equity mandate could be in the region of 0.1% – 0.2% of the value of funds transitioned.
- The costs of any rationalisation would depend on a number of factors including whether there was any increase in the usage of passive management across the equity and bond portions of the resulting fund(s).
- We believe that the potential savings in investment management fees from rationalising the investment management arrangements would not be significant enough to justify in cost terms alone moving from the current structure to 1, 2 or 3 funds.
- While extensive use is made of active investment management across the 11 funds, there is no evidence that this has been of benefit at the collective level, with the combined assets having underperformed the combined benchmark by approximately 0.2% p.a. over the 3 years to 31 March 2010.

- Active investment management incurs higher investment manager fees than passive management but there is no evidence to suggest that at the combined level the payment of these higher investment manager fees has resulted in outperformance.
- It should be noted however that at the individual fund level, there are some funds where the overall management of the assets has been beneficial relative to their respective benchmarks in recent years.
- There is no clear evidence to suggest that moving from the current structure to larger funds would result in an improvement in performance.
- The governance arrangements across the 11 administering authorities vary, with the larger funds delegating elements of the management of the investment arrangements to sub committees. Overall there is less usage of external advice relative to equivalent sized schemes in the private sector. With a number of funds introducing or increasing their allocation to alternative investments, there appears to be a lack of external advice being taken (based on the reported level of fees being paid) for investments which significantly increase the underlying investment fees being paid.
- We believe that there are risks linked to the relatively low level of resourcing across most of the funds, leading to a “key man risk”, and potential generational issues as individuals with experience and knowledge leave the administering authority. This is not helped by the fact that membership of the pensions committees is determined following local government elections which has resulted in a lack of continuity in the membership of pensions committees.
- We believe that there could be potential benefits from moving to larger fund structures in terms of the cost effective implementation of improved investment governance arrangements such as increased external advice and mitigation of key man risk and we recommend that this is further explored.
- If the current structure is maintained there would be benefits, particularly for some of the small and medium sized schemes, if a central resource was made available that could provide technical advice and assistance to officers and elected members on some of the more complex investment opportunities and issues.
- Consideration should be given to relaxing the current constraints on the proportion of assets that can be invested in a single fund or insurance policy where the underlying investment is being managed on a passive or index tracking basis to allow a higher proportion of assets to be managed passively and resulting in lower investment management fees. This applies whether merger is undertaken or the current 11 fund structure maintained.

2 Future Administration Options

2.1 Introduction

This section of the interim report summarises the results of an options appraisal carried out on current and alternative pensions administration options and describes the approach taken, the findings of the appraisal and our overall recommendations.

The options appraisal was built upon cost and service information gathered by the Improvement Service and Deloitte, supplemented by input from the stakeholders from current administering authorities and looks to balance the benefits and risks which can arise from adopting a changed administration delivery model, in order to identify balanced and appropriate recommendations. The Scottish Public Pensions Agency has also provided input with regards to the current regulatory framework.

To assist in assessing the range and depth of services provided by the current administering authorities we have developed the concept of “core” and “non-core” administration services. Core services are those administrative requirements which are either required under legislation or form such as integral part of the administration delivery that their performance is deemed essential. Non-core services are other supplementary services performed by the administering authorities which, whilst providing an enhanced quality or range of services, are not deemed to be essential. The ability to deliver against the core services, and the treatment of the non-core services, has formed an important part of the options appraisal.

2.2 Options appraised

We have carried out an appraisal of future administration options for the LGPS in Scotland to complement the fund merger options identified under the Investment Management workstream. The administration options have been considered independently, however, and we have not assumed that the structure of the administration service delivery model must be identical to that of investment delivery model. The potential future administration service delivery models that have been defined for consideration under Phase Two of the Project are:

a. Maintenance of current arrangements;
b. Maintenance of current arrangements with a revised approach to delivering services;
c. Merger of administration services into one, two or three centres; and
d. Transferring of pensions administration services to an external provider.

2.3 Maintenance of current arrangements

Under this option there would be no change to the status quo with each of the 11 funds providing administration services independently. Current services and service levels, as well as administration governance and oversight arrangements, are assumed to continue unchanged.

2.4 Maintenance of current arrangements with a revised approach to delivering services

Under this model, the current structure for delivery of future pensions administration services from 11 pensions administration centres would be maintained however the way in which services are defined and delivered would be revised to capitalise on opportunities for future cost savings, service improvements, risk management and greater consistency in services across the LGPS in Scotland.

We have identified and considered the following mutually exclusive options which could be implemented together or separately:

a) - Standardisation of services and service levels;

b) - Standardisation of administration governance and oversight arrangements; and

c) - Shared administration system and operating model.

Each of these options would require voluntary co-operation between the current Funds, both to develop the detail and then to implement. In the appraisal section we have given a view as to whether costs are expected to increase or decrease from current levels as a result of these changes.

2.5 Merger into 1, 2 or 3 administration centres

This option considers the alignment of future pensions administration service delivery with proposals being considered under the Investment Management workstream for merger of the current 11 LGPS funds in Scotland into 1, 2 or 3 funds. The administration options have been considered independently, however, and we have not assumed that the structure of the administration service delivery model should mirror that of investment delivery model.

2.6 External transfer of pensions administration services

Under this model, pensions administration services would be transferred to an external service provider. For the purposes of this options appraisal, two distinct options have been identified as follows:

a. **Transfer to the Scottish Public Pensions Agency (SPPA)**
All administration services for the LGPS in Scotland would be taken over by the SPPA. The SPPA currently provides pensions administration services for the NHS and Teachers' Pension Schemes in Scotland covering over 450,000 members. The SPPA also provides legislative services for the LGPS in Scotland on behalf of Scottish Ministers.

b. **Transfer to a private sector pensions administration provider**
All administration services for the LGPS in Scotland would be outsourced to a private sector pensions administration provider.

2.7 Options appraisal criteria

This section summarises the approach that has been taken to appraise the options identified and summarised above.

2.7.1 Costs

The cost of providing the pensions administration services is one of the main factors which will influence any decision to remain with the status quo, or adopt an alternative model. Where possible, cost estimates in relation to the administration models under consideration have been prepared and are considered as part of the options appraisal. Cost details for the current state have been based on the Administration Management Workstream Summary Analysis Report and estimates for the alternative models have been prepared or obtained for the purposes of this report based on assumptions and research carried out.

2.7.2 Service comparison

Whilst cost is an important consideration, the range and quality of services provided to LGPS members, local authorities and other participating employers is also a primary consideration and must be taken into account when considering the various pensions administration delivery models. Some of the models under consideration could result services being provided differently, or in local authorities or employers having to change the way in which they interact with the LGPS. This section of the options appraisal considers how such changes in services could impact upon LGPS members, their employers and local authorities.

2.7.3 Benefits

This section of the options appraisal considers the potential benefits the proposed administration models would deliver to LGPS members, local authorities and other participating employers.

2.7.4 Risks

Although changing the pensions administration delivery model may deliver a number of benefits there are risks which need to be recognised and addressed. The options appraisal considers the risks the proposed administration models create for the delivery of services to LGPS members, local authorities and other participating employers.

2.7.5 Political acceptability and impact assessment

Given the current economic and political climate, a great deal of focus is being placed on the delivery of public sector services. Changing the pensions administration delivery model has implications beyond the LGPS members and the staff administering the LGPS on behalf of the administering authorities. This section considers how various stakeholder groups, including parties such as the LGPS scheme members, LGPS staff, local authorities, participating employers and Scottish Government Ministers might perceive the different administration models under consideration.

2.7.6 Implementation assessment

If an alternative pensions administration delivery model is to be adopted then the transition towards this will need careful planning and management if the change is to be implemented successfully. Transition will be further complicated by the need to continue to manage the ongoing pensions administration services while transitioning to a new model. The options appraisal considers how the transition to alternative models will be managed and resourced, including an assessment of potential issues.

2.7.7 Governance implications

Any change from the current model may require a change in the governance and oversight of the administration functions. This section considers how future governance of administration services could be achieved under the various models, including consideration of what new processes may be required and how local authority views will be captured and represented under the alternative models.

2.8 Data used in options appraisal

2.8.1 CIPFA returns

The cost and volume data for the current state has been drawn from the CIPFA benchmarking study carried out in 2010, with an allowance made for any authority which did not participate in the benchmarking study. This has been used to determine per member costs for the various administering authorities, and a weighted average per member cost, which can be used as a benchmark for comparing the various options.

Based on the CIPFA cost data, we have removed any disclosed actuarial or external audit costs and identified that current administration costs are in the range of £16.92 to £64.30 per member (although it should be noted that the £64.30 per member cost for Orkney is significantly higher than the next highest cost £27.37 and could be considered an outlier).

The weighted average cost across the 11 administering authorities in Scotland (excluding any disclosed actuarial and audit costs) is £20.92 per member.

2.8.2 Modelling host authority costs on merger

Criteria identified for determining potential host authorities under the merged models include:

- the expected future cost per member;
- the size of current administration operations;
- the ability and willingness to scale up;
- the range and quality of services; and
- the location and availability of resources.

Actual future costs under any of the three merger option will, however, be a function of the new operating models developed by host authorities to provide both their existing services plus the services for ceding authorities.

However, for modelling purposes only, applying the current per member costs of the largest and lowest cost administration centres under each of the three merger options, produces the following cost savings/(increases) when compared against current costs:

Merger Option	Largest fund as host Annual Saving/(Increase)	Lowest cost fund as host Annual Saving/(Increase)
1 Fund	Strathclyde Annual saving = £196k	Falkirk Annual saving = £2.65m
2 Funds	Strathclyde (West) Lothian (East) Annual increase = (£854k)	Dumfries & Galloway (West) Falkirk (East) Annual saving = £2.2m
3 Funds	Strathclyde (West) Lothian (East) North East (North) Annual saving = (£105k)	Dumfries & Galloway (West) Falkirk (East) Highland (North) Annual saving = £2.0m

These savings (or increases), have been fed into the options appraisal. There would clearly be scalability issues in selecting small or medium sized funds as future host authorities.

More details on the source cost data used for the options appraisal can be found in the Administration Management Workstream Summary Analysis Report.

2.8.3 Services to be appraised

To enable a fair assessment to be made of different administration models we have developed the concept of "core" and "additional" administration services. The "core" services are those defined through legislation, primarily the Local Government Pension Scheme (Administration) (Scotland) Regulations 2008 and the Local Government Pension Scheme (Benefits, Membership and Contributions) (Scotland) Regulations 2008. We have also taken into account relevant amendments. A number of core administration functions also arise through other legislation such as the Pensions (Increase) Act 1971 and 1974, the Freedom of Information (Scotland) Act 2002 and relevant tax legislation.

The "additional" services are the supplementary services which are provided to employers and members to provide a more complete and supportive experience for these parties. Although not defined in legislation, many of these additional services still form an essential part of the overall pensions administration service and have, therefore through consultation with current LGPS administration officers, been deemed to be “additional core services”. Other activities, which are not deemed to be essential, have been deemed to be “additional non-core services”.

The current administering authorities were asked to confirm which additional services they provide. Analysis of this information has confirmed that there is no consistent approach adopted with regards to the range of the additional services provided, or how these are provided. Further information on this point can be found in the Administration Management Workstream Summary Analysis Report.

When considering the different administration models we have assumed that the services merged or outsourced are the core services plus the additional core services.

2.9 Options Appraisal Workshop

To assist in the development and the completion of the options appraisal, a workshop was held at the Deloitte office in Edinburgh on 21 March 2011. This workshop:

- reviewed the core and additional services which had been identified, to help develop a comprehensive and agreed list of services;
- considered the benefits and risks associated with changing the pensions administration delivery model;
- considered what transition management and governance arrangements would be necessary and appropriate during any move towards a revised pensions administration delivery model; and
- reviewed the impact and acceptability of the different pensions administration delivery models amongst various internal and external stakeholder groups.

Considerable time was given to reviewing and refining the list of core, additional core and non-core services which were identified, and an updated list was agreed which could be used for understanding the services which would have to be provided under a merged or outsourced administration model.

Identification of appropriate host authorities under the merged administration models was also discussed, and selection criteria noted included current size and experience, ability and willingness to scale up, range and quality of services provided and the location and availability of resources.

Conclusions from administration options appraisal

A summary of the conclusions from the administration options appraisal is set out in the following tables

Option	Cost	Service comparison	Benefits	Risks
Maintenance of current arrangements	• At £20.92per head, the weighted average cost per member across the 11 funds compares favourably with the average per member cost for all LGPS funds in England and Wales[7] (£28.31); even allowing for higher overhead and salary costs in the London area, the average per head administration cost is lower • Our research into the shared service arrangements between Cumbria and Lancashire indicates that there is potential for the full range of LGPS services to be delivered at a cost which is lower than the Scottish weighted average • There is no direct correlation between fund size and administration cost - while the largest fund (Strathclyde) has a lower than average per member cost (£20.50) the next largest fund (Lothian) has the third highest cost (£24.42) • No implementation costs	• Services and service standards remain at current levels • Pensions administration services are broadly comparable across the 11 funds however service levels currently vary • The customer survey carried out for the Administration Management Workstream Summary Analysis Report indicates that overall employer and member satisfaction levels with services provided by the current 11 funds is relatively high – particularly from employers and pensioners; there is a desire however from employers for more electronic communications	• Localised service delivery structure maintained • No transition costs or risks incurred	• May not be delivering best value for council tax payers in the provision of pensions administration services (eg inefficient purchasing of services and resources) • Some of the funds provide administration services with less than 4 full time equivalent staff and this creates a potential risk to service delivery should staff be unavailable for prolonged periods (for whatever reason) • Smaller funds may have difficulty in recruiting replacement future administration staff

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Maintenance of current arrangements with revised approach to service delivery **Enhancement A - Standardisation of services and service levels**	• Given the considerable variance in scale and administration resources between the largest and smallest funds, and the assumption that standardisation of services and service levels would involve "levelling up" to current best practice, we would expect that there would be an ongoing increase in costs for those funds whose services or service levels are currently below best practice levels • Any additional costs of levelling up to best practice standards could be mitigated, in part, by agreement to levy additional charges across the 11 funds to employers and members for non-core additional services	• Standardisation of services and services levels, and formalised reporting of actual performance against these levels, would allow for greater transparency in future service delivery and cost as well as opening up the potential for future cost sharing in areas such as communications, training and the procurement of third party services.	• Localised service delivery structure maintained • Standardised services and administration governance across LGPS in Scotland • More transparency and ease of comparability of future costs and service levels in line with IPSPC recommendations	• Resource required from each fund to develop and implement the new standards could put maintenance of business as usual at risk • Absence of a single body with a mandate to define or implement the standard services risks non or sub-optimal implementation
Maintenance of current arrangements with revised approach to service delivery **Enhancement B – Standardisation of administration governance and oversight arrangements**	• We would expect a small increase in ongoing costs if current administration governance and oversight arrangements were levelled up to best practice standards • Any increase in costs could be justified in terms of the increased transparency and assurance that it would provide in relation to how future pensions administration is carried out and charged for; this will support ongoing analysis of scheme administration efficiency	• Service levels would be expected to increase for some funds if current services and standards are levelled up to best practice levels	• Localised service delivery structure maintained • Standardised services and administration governance across LGPS in Scotland	• Resource required from each funds to develop and implement the governance arrangements could put maintenance of business as usual at risk • Absence of a single body with a mandate to define or implement the governance arrangements risks non or sub-optimal implementation

Maintenance of current arrangements with revised approach to service delivery **Enhancement C – Shared administration system and operating model**	• For some funds, annual IT cost is over 20% of total administration costs whereas for other funds IT cost is less than 10% of total cost, the lowest being 5.3% of total cost (Strathclyde) and the highest 25.5% (Dumfries and Galloway) • The detailed feasibility of this option, and associated implementation costs and ongoing operating costs, would need further investigation and will be a function of the number of funds that pursue this option • Some future costs could be mitigated by agreement to charge employers and members for agreed "non-core" services	• Any new shared administration system and operating model could be designed with improved services and may deliver to higher agreed standards than currently	• Reduced IT costs per member. • Mitigation of key man risk identified for smaller funds. • Sharing of expected costs for implementing "Hutton" benefit structure. • Maintenance of current local levels of employer and member support services	• Resource required from each fund to develop and implement the new operating model and IT systems could put maintenance of business as usual at risk • Absence of a single body with a mandate to define or implement the standard services risks non or sub-optimal implementation • Some funds operate with relatively small numbers of staff in locations where it may be difficult to recruit replacement staff
Merger into 1,2 or 3 new administration centres	• Any future costs under this option are a function of the new operating models developed by the host future authorities to provide both their existing services plus the services for ceding authorities • Applying the lowest per member costs under the 1 fund option produces the greatest annual savings at £2.65m pa • Taking Strathclyde as an example of a large scale administration centre delivering services at lower than overall average	• Future services would depend on how new operating models are developed, however larger funds (ie potential hosts) generally provide higher and more consistent services • Merger of the current 11 administration centres could result in a loss of face to face local employer and member support services, although host authorities would be expected to address this when developing their service offering	• Standardisation of services, service levels, communications and oversight arrangements could be incorporated into new operating models for selected host authorities • Any agreed Hutton changes could also be incorporated into new operating models • Previously identified "key man" risks for smaller funds would be mitigated under this option • Overall reduced management requirements and more transparent and	• Significant transition risks to address on data transfer, new process design and the establishment of links between new host authorities and all the employers under the ceding authorities • Developing new operating models will require significant investment of resources from host authorities creating risk to maintenance of business as usual

	weighted costs per member, and applying their current costs across each of the three merger options, would result in the same annual saving under each of the three options, namely £197k pa • Research on the arrangements between Cumbria and Lancashire shows that fully comprehensive LGPS administration services can be provided from one fund's administration centre to another fund's members at a lower cost than the current weighted average for the Scottish funds and applying these costs to the merger models would result in further annual costs savings		efficient oversight and reporting procedures	
Transfer to the SPPA	• As part of Phase 1 of the Pensions Pathfinder Project, SPPA was identified as a potential provider of future pensions administration services for the LGPS in Scotland as its per member pensions administration charge for the Teachers' and NHS Schemes (£12.99 per head) indicated that annual savings of £3.25m could be achieved compared to current LGPS administration costs • The Phase 1 report also noted that there was a difference in the nature of	• We have prepared a detailed schedule of LGPS administration services based on current legislative requirements as well as current operational practice, in order to ensure that the appraisal of SPPA could be considered on a like for like basis • This schedule of services has now been passed to SPPA with a request for a response on their ability to deliver these services. Subject to this response, SPPA will be provided with details on current	• Potential cost savings • More consistency of services and service levels across LGPS in Scotland • IT and staffing issues transferred to third party	• Staff transfers or potential redundancy of current administration staff • Significant transition risks (eg database transfers, establishment of links between new centres and participating employers and revised service levels) • Transfer would create potential for adverse impact on business as usual • Loss of direct control for administering

	the service provided by the SPPA for the NHS and Teachers' Schemes and that currently provided by administering authorities for the LGPS • Potential cost savings should be explored after SPPA confirm whether or not they would be able to deliver core services	administration activity levels and will be asked to provide details on costs and service levels for further consideration • If not transferred to SPPA non-core additional services would still need to be provided at local level but employers and members could be charged for these to mitigate cost		authorities • Potential lack of alignment with residual non-core services • Risk of private sector legal challenge to SPPA transfer
Outsourcing to a private sector provider	• The Phase One report estimated that potential savings of £2m pa could be achieved by outsourcing pensions administration for all 11 funds to a single administration centre run by Xafinity Paymaster at an indicative cost of £17.85 per head • Applying this indicative cost to the current membership profile and comparing it against current total LGPS costs shows that potential savings of £1.45m could be achieved • As noted in the Phase One report, however, the service package provided by Xafinity Paymaster differs from that currently provided by the LGPS funds • A market testing exercise based on recently agreed "core services" would be required to get greater insight on potential private	• Future services and service levels are not clear and market testing of core services would be required to understand potential private sector services provided • Depending on structuring of private sector transfer, local support services could be maintained but again this would require market testing to confirm • If not transferred to a third party provider, non-core additional services would still need to be provided at local level but employers and members could be charged for these to mitigate cost	• Potential cost savings • More consistency of services and service levels across LGPS in Scotland • IT and staffing issues transferred to third party • Contractual enforceability of agreed private sector services	• Staff transfers or potential redundancy of current administration staff • Significant transition risks (eg database transfers, establishment of links between new centres and participating employers and revised service levels) • Transfer would create potential for adverse impact on business as usual • Loss of direct control for administering authorities • Potential lack of alignment with residual non-core services • Risks in defining detailed procurement requirements for private sector transfer

	sector costs • Cumbria County Council recently considered whether to outsource future pensions administration to Capita (their incumbent provider prior to 1 Feb 2011) and concluded that costs were higher than their chosen option of entering into a shared services arrangement with Lancashire County Counci • An independent survey of pensions administration costs commissioned by Capita in 2010 covering over 400 schemes (including public sector schemes) showed an average cost for third party providers of £41 per member for the largest scheme size category (over 10,000 members)			

Option	Political acceptability and impact assessment	Implementation assessment	Governance	Recommendation
Maintenance of current arrangements	• Limited impact on current stakeholders • In particular, no impact on police, fire and rescue administration services • Will require evidence to demonstrate that this model is delivering best value for council tax payers	• Not applicable	• Current governance arrangements will continue • Administration governance and oversight arrangements also vary across the 11 funds with some funds not having service level agreements in place, reporting on performance to members and employers or preparing reports to elected members • There are no formal arrangements in place for collaboration and partnership working in the delivery of administration services across the 11 funds, although the SPLG provides a knowledge sharing platform that could be further developed	• On the basis that one of the objectives of the Pensions Pathfinder Project is to identify how future administration services could be delivered more cost effectively, we do not recommend that this option is considered further as part of this Project other than as a baseline comparitor
Maintenance of current arrangements with revised approach to service delivery **Enhancement A - Standardisation of services and service levels**	• Improved services for some members and employers and maintained service levels for others • Job retention for smaller authorities • Will require evidence to demonstrate that this model is delivering best value for council tax payers	• Will need collective buy in from all funds and strong management to develop and implement any future standardisation	• Standardisation of services and service levels under the 11 fund structure would require consensus what services to provide, how these are best delivered (e.g. a common channel strategy) and what levels services should be provided to • Require a resource	• We recommend that funds develop and implement standard services and service levels to improve service delivery and consistency

	• Standardisation could also be extended to administration services for police, fire and rescue		commitment from all funds, an agreed timetable for delivery and pro-active management • Achieving consensus on services and service levels will also support those funds that choose to comply with the proposed new (optional) legislative requirement[8] to prepare and publish details of their pensions administration strategy by rationalising the compliance process.	
Maintenance of current arrangements with revised approach to service delivery **Enhancement B – Standardisation of administration governance and oversight arrangements**	• Improved services for some members and employers and maintained service levels for others • Job retention for smaller authorities • Will require evidence to demonstrate that this model is delivering best value for council tax payers • Standardisation of administration governance and oversight arrangements could also be extended to police, fire and rescue administration services	• Will need collective buy in from all funds and strong management to develop and implement any future standardisation	• Agreeing common future administration governance and oversight standards and procedures will allow for greater future transparency and consistency in areas such as risk management, performance reporting, service level agreements, discretionary policies and the allocation of central charges by administering authorities to funds • Standardising administration governance and oversight arrangements would also support draft legislative requirements[9] for all funds to prepare an annual report containing (amongst other things) a report of the	• We recommend that funds develop and implement standard pensions administration governance and oversight arrangements to achieve greater consistency and transparency in the delivery of pensions administration

8 The Local Government Pension Scheme Amendment (Scotland) Regulations 2010 (Draft November 2009) – New clause 60A
9 The Local Government Pension Scheme Amendment (Scotland) Regulations 2010 (Draft November 2009) – New clause 31A

			arrangements made during the year for the administration of the fund and the requirement to prepare and publish a governance compliance statement	
Maintenance of current arrangements with revised approach to service delivery **Enhancement C – Shared administration system and operating model**	• Improved services for some members and employers and maintained service levels for others • Job retention for smaller authorities • Will require evidence to demonstrate that this model is delivering best value for council tax payers • Those funds that choose to further investigate the feasibility of this option would also need to consider how future administration should be provided for police and fire & rescue schemes	• Shared system for some funds would require the development of a new operating model and admin IT procurement • Formal Collaboration Agreement would be needed	• The shared operating model should be designed to incorporate the recommendations above on standard services and service levels as well as on standard administration governance and oversight arrangements • Formal co-operation between the funds that pursue this option should be detailed in a Collaboration Agreement between the funds to allow for collective procurement of required IT systems and any professional services	• We recommend that funds are asked to consider this option and, subject to levels of interest, a feasibility study, including costs, resource requirements and implementation plan is carried out that funds can sign up to
Merger into 1,2 or 3 new administration centres	• Loss of control of pensions costs and services for ceding authorities may not be acceptable – wider consultation required • Potential loss of local support for employers and members • Potential loss of local jobs in ceding authorities • Improvement in services and service standards combined with any cost savings will be viewed	• Criteria identified for determining potential host authorities include the expected future cost per member, the size of current administration operations, the ability and willingness to scale up, the range and quality of services and the location and availability of resources • Implementation of any merger options would require a significant	• Standardised services, service levels, administration governance and oversight arrangements could be incorporated into new host authority operating models as could new administration requirements arising out of potential future benefit structure changes • If full fund merger is not taken forward, then administration shared	• We have not established any evidence that there are economies of scale to be achieved through the scaling up of LGPS administration services in Scotland. • Administration cost data from LGPS in England and Wales indicates that there is little variation between funds in administration costs per member once a fund size of £1bn is achieved,

	positively by Scottish Government • Job losses balanced with desire to improve efficiency and reduce costs • Smaller market for advisers and suppliers • Host authorities would also need to provide administration services for police and fire & rescue schemes where these are currently provided by ceding schemes	investment, both in terms of the cost of developing the required new operating models and from resources in ceding and host authorities to effect the transition of data and knowledge of employers and discretionary practices • Costs of administration transformation to 1,2 or 3 could be charged to (merged) funds	services could be achieved with Collaboration Agreements between designated host authorities and ceding authorities • Transformation governance is critical – currently there is no single body with a mandate over existing funds	however it should be noted that the largest LGPS fund (Greater Manchester) reports annual administration costs of £14.77 per member • Uncertainty around future host authorities and the cost and commitment required to develop new operating models to accommodate ceding funds, combined with uncertainty on future possible cost savings, leads us to recommend that the three merger options identified for appraisal are not taken forward • Other merger and shared service options could be identified and investigated to mitigate the key man risk incurred by the smallest funds and to offset the impact of high fixed costs
Transfer to the SPPA	• Member and employer concerns about future services and levels • Current administration staff transfers or redundancies may be required • SPPA, as a centralised provider of administration services to unfunded schemes, should be well placed to provide administration services to	• Any transfer of services to SPPA would involve establishing a significant transformation programme to manage the process and there are transitional risks relating to database transfer, establishment of links to employers, loss of local support / staff knowledge and impact on business as usual which need to be factored in as well as	• Transferring authorities would have Service Level Agreement with SPPA • Enforceability of Service Level Agreement is not clear as any “Publi-Public” partnership agreement cannot be treated as a contract • SPPA would be expected to perform and report against agreed service levels	• We recommend that the option of transferring administration services to SPPA is considered further once SPPA responds to the recent request and provides confirmation on their ability to provide the services on the schedule and the likely cost of this

	police and fire & rescue schemes	either staff transfers or potential redundancy costs • For SPPA transfer, there would need to be full agreement between ceding authorities and SPPA on services and service levels • We have noted during our research that there was limited appetite for outsourcing to the SPPA option among the stakeholder group, therefore achieving buy in and successful implementation are likely to be difficult to secure	• SPPA currently has a role in relation to the LGPS in Scotland as the body responsible for drafting regulations on behalf of Scottish Ministers; any future role for SPPA as an administration provider would need to be structured to ensure that potential conflicts of interest are mitigated	
Outsourcing to a private sector provider	• Member and employer concerns about future services and levels • Current administration staff transfers or redundancies may be required • Separate consideration would need to be given to how future administration services should be provided to police and fire & rescue schemes if LGPS administration services are outsourced	• OJEU procurement programme would need to be established to achieve a transfer of administration services to the private sector, including detailed defining of requirements • Procurement costs for this scale of outsourcing could be significant	• Transferring authorities would have a contract with the third party private sector provider • Contract would be legally enforceable • Provider would be expected to perform and report against agreed service levels	• Given uncertainty over ongoing costs, services and service levels and the fact that based on the data available a transfer to SPPA could deliver higher potential savings, we recommend that outsourcing to a private sector provider is not taken forward. • We would expect that competitive tendering for outsourcing LGPS administration in Scotland would result in a lower cost than the £41 per member identified in the Capita survey, however, the potential cost can only be established with any certainty by carrying out a market testing exercise

3 Governance

3.1 Background

The governance and management arrangements for the LGPS in Scotland are a legacy of regulations[10] in 1975 under the Superannuation Act 1972 which prescribed that there should be separate LGPS funds for each of the 9 newly created regional councils plus separate funds for Orkney Islands Council and Shetland Islands Council. This resulted in the current 11 separate funds covering all local authority employees and other eligible employees in Scotland.

Following the re-organisation of local government in Scotland in 1996, and the creation of the current 32 unitary authorities, it was decided not to split the 11 funds created in 1975 between the 32 authorities but rather that the 11 funds should continue to be run by the legacy authorities as administering authorities. The designation of administering authorities was set out in regulations[11].

Under s.56 of the Local Government (Scotland) Act 1973 an administering authority can delegate their pension fund investment functions to the Council, committees, sub-committees or officers.

Under s.57 of the Local Government (Scotland) Act 1973, the administering authority decides on the composition of the committee and while there is no single model in operation across the 11 funds, most have established a committee comprising elected members representing the political balance of the administering authority. The terms of reference setting out the scope of pensions committees are defined independently by each administering authority and are not subject to regulatory guidance.

Some funds have established consultative panels/representative forums comprising elected members from the administering authority, representatives from other unitary authorities and participating employers in the fund, fund members and Trade Unions. A summary of the composition of the 11 investment committees and any consultative panels/representative forums is included as Appendix 1.

3.2 Future governance options

Under the brief agreed for Phase II of the Pensions Pathfinder Project, we have been asked to consider the potential future governance implications of the following models that have been identified for appraisal:

- Maintenance of the current 11 funds
- Merger of current 11 Funds into a single fund (for the purposes of this review we refer to this as Model 1);
- Merger of the current 11 funds into 2 funds (Model 2)
- Merger of the current 11 funds into 3 funds (Model 3)

[10] Local Government Superannuation (Scotland) Amendment Regulations 1975
[11] Local Government (Superannuation and Compensation for Redundancy or Premature Retirement) (Scotland) Amendment Regulations 1995

Table 1.1 - Model 2

Fund 1	Fund 2
Strathclyde Pension Fund	Lothian Pension Fund
Dumfries and Galloway Pension Fund	Fife Council Pension Fund
	Scottish Borders Council Pension Fund
	Falkirk Council Pension Fund
	Tayside Pension Fund
	North East Scotland Pension Fund
	Highland Council Pension Fund
	Orkney Islands Council Pension Fund
	Shetland Islands Council Pension Fund

Table 1.2 - Model 3

Fund 1	Fund 2	Fund3
Strathclyde Pension Fund	Lothian Pension Fund	Tayside Pension Fund
Dumfries and Galloway Pension Fund	Fife Council Pension Fund	North East Scotland Pension Fund
	Scottish Borders Council Pension Fund	Highland Council Pension Fund
	Falkirk Council Pension Fund	Orkney Islands Council Pension Fund
		Shetland Islands Council Pension Fund

Although the models for future merged fund options have been determined, no decision has been taken as to which of the current 11 administering authorities within each of the merger options would take over as the future administering authority/authorities or whether alternatively a new national Supervisory Board should be established as was proposed under Phase 1.

We have been asked to consider the future governance implications of the proposed investment management and administration options within the current legal framework for the LGPS in Scotland and how this might be achieved. In particular, we have been asked to provided responses to a series of 28 specific governance related questions and these are set out in Appendix 5.

By agreement with the Improvement Service and COSLA, for this interim report we have not considered the specific options around alternative future governance models relating to the establishment of a new governance board which would see responsibility for the LGPS ceded from the current administering authorities to this new board. We have, however, referenced in section 3.3.4 some examples of current pensions governance best practice, including reference to the Independent Public Service Pensions Commission final report.

3.3 Summary of research and analysis

3.3.1 Delegated responsibility and representation

We have researched the current legal position in relation to the composition of pensions committees established by administering authorities. In particular we have sought to establish the extent to which other stakeholders, including representatives from other unitary authorities, scheme members, other employers and professional experts could have voting rights on future pensions committees.

As noted in section 3.1, overall responsibility for the current 11 funds is delegated to the 11 designated administering authorities who in turn delegate investment and other responsibilities to committees comprising elected members from that authority[12].

Currently, each fund includes a range of participating employers covering the 32 unitary authorities in Scotland plus Scheduled Bodies and Admitted Bodies. Some of these employers are represented, along with members and other stakeholders, on non-voting consultative panels and representative forums which have been established by some funds.

The Heads of Agreement for the new LGPS in Scotland prepared by the Scottish Local Government Pensions Advisory Group (SLOGPAG) in 2008, agreed that regulations governing the new scheme should include a provision for each administering authority to publish a statement setting out details on its position on the delegation of responsibility to committees, sub-committees or officers.

As a result, regulations[13] were issued which included a requirement for all administering authorities to publish a governance compliance statement setting out whether they delegate their function in relation to maintaining a fund to a committee, sub-committee or officer and where they do, a further requirement to publish relevant details. The regulations also contain provisions for Scottish Ministers to prepare and publish guidance relating to the preparation of governance compliance statements.

In November 2010, Scottish Ministers (through SPPA) published guidance to all administering authorities which included an invitation to enhance existing governance arrangements by broadening the membership of pensions committees to include stakeholders in the Fund other than the elected members of the particular administering authority. Further, the guidance advised that pensions committees could include representatives from other employing authorities, scheme members and other representatives subject to meeting an eligibility requirement[14].

Following publication of the guidance from Scottish Ministers, a legal question has been raised as to whether the appointment of wider stakeholders to a pensions committee would breach s.57(3) of the Local Government (Scotland) Act 1973 which restricts membership of a committee to elected members where that committee regulates or controls the finance of the local authority or of their area.

We have raised this legal question with SPPA who have confirmed that a pensions committee is a committee set up to deal with matters concerning the management of the fund and not a committee for regulating and controlling the finance of the local authority and as such there is no restriction on the appointment of voting members to the committee who are not elected members of the administering authority.

3.3.2 Legal position on fund merger

We have researched the legal position in relation to how any future fund merger could be achieved.

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[12] Highland Council Pension Fund currently has an elected member from Western Isles Council on its elected member Pensions Committee
[13] The Local Government Pension Scheme (Administration) (Scotland) Regulations 2008
[14] Eligibility rules for any committee established under s.57 of the Local Government (Scotland) Act 1973 are set out in s.15 of the Local Government and Housing Act 1989

SPPA has advised that any future merger of the 11 funds into one or more new funds could be achieved through the enacting of amending regulations under powers delegated to Scottish Ministers under the Superannuation Act 1972. In particular, they have advised that no new or amending primary legislation would be required.

SPPA has further advised that they would normally expect that new regulations achieving a merger of the existing Funds would take between 6 to 9 months to execute.

In relation to specific questions in our brief which envisage the establishment of a new governance board to take over responsibility for the LGPS in Scotland, SPPA has advised that they would require details of the delegated responsibilities that the new governance board would be expected to have, as well as details on the proposed composition of its voting members, before they would be in a position to advise on the legal requirements to achieve this.

As noted above for the purposes of this interim report we have been asked to focus on what can be achieved under the current legal structure and have not investigated alternative governance structures as part of this initial phase of research.

3.3.3 Political acceptability

As noted above, the current position whereby designated administering authorities have legal responsibility for pension arrangements covering other unitary authorities and participating employers has arisen as a legacy of regional and local government re-organisation over the last 35 years.

Research and analysis to date under this phase of the Project has been based primarily on input from pensions officers from the current administering authorities, as well as from the SPPA, and we have not yet been able to establish the views of wider stakeholders. In particular we have not been able to establish the views of wider unitary authority stakeholders on both the current governance arrangements as well as any proposals to change to these as a result of any future fund mergers.

Any future merger under the current delegated legal structure would result in one, two or three administering authorities taking over responsibility for the current 11 funds. We believe that this raises questions on whether the current composition of elected member committees would give sufficient representation of wider employers and members interests on key decisions. As an example, we summarise below the governance arrangements for the three largest funds under each of the three future merger options that have been defined:

Fund	Elected Member Committee	Consultative Committee	Advisory Panel
Strathclyde	8 x City of Glasgow Councillors	**SPF Representative Forum** 12 x LA reps. 4 x Scheduled Bodies. 2 x Large Admitted Bodies. 2 x Admitted Bodies. 5 x TU reps. 1 x Pensioner rep 2 x Chair and Alternate	**SPF Investment Advisory Panel** 3 x independent advisors. 1 x rep from fund's investment consultants and actuary. Director Financial Services. Head of Pensions Chief Pensions Officer
Lothian	5 x City of Edinburgh Councillors	**LPF Consultative Panel** 1 x convenor 7 x employer 8 x employee representatives	**LPF Investment Strategy Panel** Director of Finance Head of Investment and Pensions Investment Manager 2 x Investment consultants

North East Pension Fund	4 x Aberdeen City Councillors	**Joint Investment Advisory Committee** 4 x Aberdeen City Councillors 2 x Moray Council Councillors 1 x Scottish Water rep 1 x Colleges of Further Education	No advisory panel in place

The final report from the Independent Public Service Pensions Commission (IPSPC)[15] makes specific recommendations in relation to the future governance of public sector schemes, including the LGPS. Recommendations include the establishment of properly constituted pensions boards, wider representation on boards (including member nominated board members), training for all board members and independent oversight of LGPS governance and administration arrangements.

While the UK Government has announced that it accepts all the recommendations made by the IPSPC and will commence consultation on these proposals in autumn 2011, we note that the Scottish Government has not yet responded formally in relation to public sector schemes in Scotland, including the LGPS.

3.3.4 Pensions governance best practice

Although constituted differently (under trust law as opposed to under statute), large trust based private sector pension schemes provide a useful benchmark when considering future pensions governance for the LGPS.

Over the last 20 years, there have been significant changes to the responsibilities of private sector trustees which have strengthened the overall governance structure for private sector pension schemes. These include a clear distinction between the responsibilities of trustees and employers, prescribed levels of member representation and defined standards of trustee knowledge and understanding. Private sector pension scheme trustees are also subject to fiduciary duties under trust law.

In 2010, the Principal Civil Service Pension Scheme (PCSPS), a large unfunded public sector scheme, established a new Scheme Management Board with delegated responsibility under the Superannuation Act 1972 for the management and administration of the PCSPS.

The PCSPS Scheme Management Board includes member and employer representatives, a representative from HM Treasury as well as non-voting external professionals with expertise in risk management and operations. The new Board as defined terms of reference which include specific responsibility for:

- Managing the scheme in accordance with relevant legislation and rules;
- Developing and managing a risk management framework and internal controls system; and
- Oversight of the scheme administrator

In addition, the PCSPS board agrees participation terms with employers which set out details on the level of service employers can expect as well as the obligations on employers in relation to data provision and other matters. The new PCSPS Scheme Management board has been identified by the IPSPC as a potential model for future governance of public sector schemes.

[15] Independent Public Service Pensions Commission: Final Report – 10 March 2011

In 2009, the Organisation for Economic Co-operation and Development ("the OECD") published guidelines[16] for pension fund governance. These guidelines set out specific recommendations on:

- Identification of responsibilities;
- The role of the governing body;
- Accountability of the governing body;
- Suitability of governing body members;
- Delegation and expert advice;
- Independent audit;
- Actuarial advice;
- Custodianship of assets;
- Risk based internal controls;
- Reporting; and
- Disclosure.

While these examples of pensions governance best practice and guidance can be referenced when considering the future governance arrangements for the LGPS in Scotland, they need to be balanced against the role of elected members and in particular their fiduciary duty to taxpayers. Broadening the role of current pensions committees, with reference to current pensions governance best practice, will require additional resources both in terms of additional time to execute the role and also on the levels of officer and professional support that may be required.

Two of the funds (Strathclyde and Lothian) have established investment strategy/advisory panels to provide specialist advice and support for elected member committees on investment matters. These panels comprise external investment professionals and senior officers. Under any merger options, we would propose that host authorities have similar specialist investment advisory panels (where these do not currently exist) to allow for a higher level of professional expertise and input into investment decisions. Where it is decided not to merge schemes, then there is an opportunity to establish a shared specialist investment resource covering medium sized and smaller schemes.

3.4 Recommendations

In relation to the governance implications of the proposed options under the Pensions Pathfinder Project, we make the following interim recommendations for further work under the Governance and Implementation planning workstream:

- Model terms of reference for LGPS pensions committees in Scotland should be developed which clearly and consistently define the role and responsibilities of pensions committees, referencing current pensions governance best practice where appropriate and building on existing governance compliance guidance; wider stakeholder consultation should be carried out in developing the model terms of reference.
- Once developed, the terms of reference should adopted and implemented by all pensions committees either under the current 11 fund structure or under any future merged fund structure and consideration should be given to regulatory guidance on implementation.
- Membership of pensions committees should be extended to include representatives of other employers, member representation and external professional representation; this will be particularly relevant if funds are merged.

[16] OECD Guidelines for Pension Fund Governance – June 2009

- If merger is not progressed, the establishment of a shared specialist investment advisory resource comprising a panel of investment professionals and fund officers to support smaller schemes should be considered.

Appendix 1 – Current governance arrangements

FUND	COMMITTEE(S) DEALING WITH INVESTMENT OF LGPS FUNDS	MEMBERSHIP OF COMMITEE	FREQUENCY OF MEETINGS
Aberdeen	**Pensions Panel [PP]** – similar role as Trustees. All members have equal voting rights. **Joint Investment Advisory Committee [JIAC]** – monitor investment management and make recommendations to the PP. All members have equal voting rights. Also member of the Local Authority Pension Fund Forum (48 funds involved).	**PP consists of**: 4 x ACC elected members (one from each major political party). **JIAC consists of**: 4 x Aberdeen CC 4 x Aberdeenshire Council 2 x Moray Council 1 x Scottish Water 1 x Colleges of Further Education	PP meet quarterly. JAIC meet quarterly with fund's Investment Managers. JIAC then makes recommendations to the Pensions Panel. * Although there is no employee representation on either Committee, ACC as the Admin Authority will hold a meeting with employee representative on request.
Lothian	**Pensions and Trusts Committee [PTC]** – has delegated responsibility (from the Council) for the supervision of funds. **Lothian Pension Funds' Consultative Panel [LPFCP]** Members have no voting rights.	**PTC consists of**: 5 x Councillors from CEC **Consultative Panel** The membership of the Consultative Panel shall be :- (a) The Convener of the Pensions and Trusts Committee; (b) Seven employer representatives. One member will be appointed by Communities Scotland. The remaining five members will represent other participating employers; (c) Eight employee representatives, all of whom are members of the Local Government Pension Scheme, which are administered by the City of Edinburgh Council. Five contributing members will be appointed by the Trade Union Consultative Committee, two contributing members will be appointed by an alternative route. One pensioner representative, being a person in receipt of a pension from Lothian Pension Fund, will be appointed by the Trade Union Consultative Committee.	PTC meets three/four times a year. LPFCP meets three/four times a year, or more frequently as appropriate.

FUND	COMMITTEE(S) DEALING WITH INVESTMENT OF LGPS FUNDS	MEMBERSHIP OF COMMITEE	FREQUENCY OF MEETINGS
Lothian Cont'd	**Investment Strategy Panel [ISP]** - oversees the investments of the fund. Please see links below to the Lothian Pension Fund website, showing the fund's Governance Policy Statement and the Statement of Investment Principles. **http://download.edinburgh.gov.uk/lpf/public/govpolicy.pdf** Also member of the Local Authority Pension Fund Forum.	**Investment Strategy Panel** Director of Finance; Head of Investment and Pensions; Investment Manager, two Investment consultants.	ISP meets four times a year, or more frequently as appropriate.
Strathclyde	**Strathclyde Pension Fund Committee [SPFC]** Perform a role similar to Trustees. **SPF Representative Forum established in 2005 [SPFRF]** **Investment Advisory Panel [IAP]** **Note: *GPS is titled Policy on Representation**	**SPFC consists of:** 8 x Glasgow City Councillors. **SPFRP consists of**: 12 x LA reps. 4 x Scheduled Bodies. 2 x Large Admitted Bodies. 2 x Admitted Bodies. 5 x TU reps. 1 x Pensioner rep. 2 x Chair and Alternate. **IAP consists of**: 3 x independent advisors. 1 x rep from funds investment consultants and actuary. Director Financial Services. Head of Pensions. Chief Pensions Officer (investments).	Quarterly.
Fife	Superannuation Fund Pensions Sub-Committee	9 x elected members. 2 x trades union reps (observer status only, no voting rights).	Quarterly.
Tayside	Superannuation Investment Sub-Committee of the Policy and Resources Committee	7 x elected members. 3 x observer members who represent scheme members.	Quarterly.
Falkirk	Investment Committee [IC] Investment Forum [IF] Member of LAPFF	IC has 6 elected members. IF is open to reps from each of the employing bodies and TUs.	IC – Quarterly. IF – Quarterly prior to IC meeting. Note revised arrangements after consultation. IF is now held in September followed by an Annual Pensions & Investment Conference held in March.
Borders	Pensions Fund Sub-Committee	2 x Depute Leader. 1 x Finance Portfolio Holder.	

FUND	COMMITTEE(S) DEALING WITH INVESTMENT OF LGPS FUNDS	MEMBERSHIP OF COMMITEE	FREQUENCY OF MEETINGS
Borders Cont'd		2 x Executive Members. 1 x Conveyor. 2 x from the opposition.	Quarterly.
Dumfries & Galloway	Investment Sub-Committee Says they have SIP & Compliance statement but cannot find on website	11 x Councillors. 3 TU reps have observer status and can participate in discussions but have no voting rights.	Quarterly.
Highland	Pensions Committee (Investment Advisory Group) (sub-committee of the resources committee)	6 elected members (5 from Highland, 1 from Western Isles).	Quarterly.
Shetland	Pension Fund Management Consultative Committee Above Committee reports to full Council, which takes investment decisions.	3 councillors. 1 pensioner. 1 union rep. 1 council employee. 1 admitted body employee. 1 admitted body employer.	Quarterly.
Orkney	Investment Sub Committee Remit of this sub-committee is to manage the investments of the Council, including the Pension Fund.	Convener & Vice Convener. 3 x Councillors.	Twice yearly (but aiming for quarterly).

Source: The data in the above table is extracted from Table A appended to "Local Government Pension Schemes in Scotland Governance Compliance Statements Guidance" published by the Scottish Public Pensions Agency in November 2010

Appendix 2 – Investment officer interviews

The following questions formed the bases of our discussions with the Pensions Officers of the eleven administering authorities. The interviews took place over a two week period between 11th and 25th February 2011.

In considering the responses it should be noted that it is difficult to determine to what extent the views provided are those of the administering authorities or of the individual officers being interviewed.

Scheme Governance

1. Would officers favour changes to the current structure?

   Most funds were satisfied with the current governance structures in place with some recognising that there was room for improvement. It was noted that the new CIPFA requirements are likely to require amendments to governance structures and that the Hutton Report was likely to recommend further changes.

2. Do officers exercise much delegated power? Could more decisions be delegated?

   There was a mix of delegated powers amongst officers. Some have no direct powers with all issues referred to their committees while others will make a judgement on materiality and only revert to their committee for substantial decisions. The Officers will typically control the agenda for committee meetings.

3. How are members elected to the pension committee and what training is provided?

   Members are elected to pension committees following local government elections. The committees will tend to comprise a split of councillors mirroring the political balance of the administering authority. Schemes provide training for committee members and training logs are maintained. The stability of committee members varies across the schemes. In respect of the Chair of committees, some schemes have seen more turnover than others. There are various lengths of tenure of committee member and differences in committee member experience across the schemes.

4. Is there an investment sub-committee/advisory panel? What is the structure of the investment sub-committee/panel? What are the terms of reference for the investment sub-committee/panel?

   Not all schemes have investment sub committees/advisory panels. Where sub-committees are in place, the degree of delegation to the sub-committee varies between schemes.

5. What external resource does the Committee use?

   Only a handful of the schemes employ an independent investment adviser. While all schemes use investment consultants, the level of investment consultant input varies greatly with some using investment consultants only infrequently. Other schemes seek investment consultant advice on an ad hoc basis for specific projects/exercises whilst a limited number use investment consultants on a regularly and ongoing basis.

6. What resource is responsible for dealing with investment issues? To what extent is there key man risk?

   Officers involved with investment have typically been involved with the pension schemes for a number of years and have a wealth of experience. For some schemes, internal resourcing dictates the number of investment managers the scheme employs, however more resource would be supported if it was thought that additional managers would bring benefit to the scheme. Some officers would welcome additional resource for managing the schemes. It was recognised that there was an element of key man risk in the running of the schemes.

In some council's the pension scheme is operated as a core business whilst for others it is not. Pension issues therefore have a higher profile in some councils than others.

Size of fund assets

1. Is the size of the fund an issue? Does the size inhibit the fund from doing things? How does size affect the number and type of managers and mandates?

   No schemes felt that asset size was a constraint. Smaller funds noted that they have access to some smaller managers and opportunities which some of the larger funds may not be able to access. Smaller funds also recognised that their size may impact allocations to specialist managers or alternative investments however the smaller funds are not convinced about the benefits of the increased complexity associated with some of these types of investments.

   Some of the largest funds did recognise that capacity can sometimes be an issue and that this could be exacerbated should there be an amalgamation into a larger fund.

2. Does the size of the fund affect the level of the resources you can commit to investment issues?

   No officers felt that scheme size impacted the level of resources that could be committed to investment issues.

3. Do you believe fund size has an impact on fund performance?

   No officers felt that fund size had an impact on fund performance. The general feeling was that bigger does not necessarily mean better. Some officers recognised that an amalgamated fund with a governance structure in place which included investment expertise might be beneficial.

4. How important is your fund's strategic asset allocation, relative to having a central asset allocation determined by a larger fund?

   Some officers noted their committee's preference to maintain their fund's strategic asset allocation rather than have a central asset allocation determined by a larger fund. Council's contribute into the pension schemes so committees want to retain a say in how the assets are managed.

Admitted bodies

1. How do you work with admitted bodies?

   The extent to which committees/officers interact with admitted bodies varies between schemes. Typically there are forums and seminars held for stakeholders of the schemes.

2. Do you think these relationships would be affected if funds were amalgamated?

   The general feeling was that local relationships would suffer if funds were amalgamated and there would be a loss of local accountability. If there was amalgamation into one fund it was highlighted that some admitted bodies will become very small and very remote from the central governing body.

Other

1. Are there other assets in addition to the pension fund which the Committee/Officers have responsibility for?

   Most committees and/or officers are responsible for other assets in addition to pension funds assets. Typically these assets are minimal in comparison to the pension funds.

2. What do you think are the key issues of fund amalgamation?

   In general, officers feel the current structure works well and the schemes operate efficiently under the current framework. The Scottish LGPS model is considered a good example of shared services in its current form by some officers. Officers believe that the LGPS is not broken and that there are other issues within the public sector that require change.

Officers cited a number of issues and observations with fund amalgamation which are summarised below:

- LGPS in Scotland already diversified – 11 schemes doing different things;
- Over/under management of a larger amalgamated fund;
- Increased costs if scheme or schemes were to get too big;
- Governance during the transition to an amalgamated fund;
- The transition costs of amalgamation;
- Staffing issues;
- Timescales;
- The undoing of investment positions already in place;
- Potential for broader range of assets if schemes bigger, however does it just become overly complicated and over diversified;
- As scale of mandates increase whether the ability to transact at best value is diminished;
- Probable diminished corporate governance costs;
- Protection of funding levels and contribution rates;
- Protection of fee arrangements of investment managers which have been in place for some time;
- Size of mandates per manager;
- If amalgamated to one fund “all eggs in one basket”;
- Whilst amalgamation may lead to a fee reduction it is a consolidation of risk;
- Who owns liability data issues if amalgamated into one fund?
- Impact on contribution costs;
- Additional costs of independent board;
- Any economies of scale could be reduced by increased manager fees due to more complex arrangements eg growing investment in alternative investments;
- Economies of scale diminish if more than one fund;
- Reputational risk of one model.

Appendix 3 – Investment data qualification

Below is an extract from the data qualification provided with the LFR24 analyses for investment data. While this refers to Phase 1 of the Pathfinder project it is also applicable for the data provided for Phase 2.

CIPFA (Scotland) Pensions Sub Group

LFR24 Analysis

The CIPFA (Scotland) Pensions Sub-Group was formed in 1996, at the on-set of the last round of local government re-organisation in Scotland. It is a group of local authority practioners involved with the LGPS. In addition to Scottish Pension funds, 3 English and NILGO participate in quarterly meetings. The Group directs its efforts towards investment matters, although some of the people are also involved with benefit issues.

Commentary on Pathfinder Project investment data

Please note that the CIPFA Group have severe reservations with regard to this data being used for comparison purposes or for the basis of potential future cost savings if the administrative structure is changed.

When it was first highlighted that the Improvement Service (IS), were likely to ask for this data to start informing the project, the Pensions Sub-group decided to review their individual submissions for the year 2007/08. However, at no time have the previous 4 years figures been given the same scrutiny.

The original collation of this LFR24 analysis was for the internal use of the Group who understand fully the limitations of the data and arose through the collection of 3 figures on a Scottish Government return i.e. investment administrative costs, benefit administrative costs and investment management costs. At no time has the analysis been used for DIRECT comparison between authorities as each Council works in a different way.

Points to Note

1. Although we collect data for 3 English Authorities and Northern Ireland Local Government Officers Scheme (NILGO), the data for these 4 schemes has been excluded, at their request.
2. The figures for the Benefit Admin Costs, Investment Admin Costs and Investment Management Costs are expected to reconcile with the LA' s published accounts. This has not been checked.
3. The cost of Benefits Administration and the further analysis has been removed from the data. There is a separate Pathfinder work stream looking into this area.
4. Market Values – some of these figures may be market value of assets under management and may exclude any internal cash being held by the local authority.
5. Market Values – some funds may have direct property investments, the value of which are not included in the information in the LFR, nor is the investment income included.
6. Membership Numbers – on Data 2 – there is a concern about inconsistencies of what is included in these figures e.g. frozen members etc. On that basis, for 2007/08, an additional set of membership numbers was sought to use in calculations. This was the membership numbers used in the actuarial valuation as at 31/3/08.
7. Staffing – The majority of investment admin staff in Scotland are not dedicated to the Pension Fund, rather they will work on several areas. As such, it is difficult to quantify true saving in staff costs if the investment process were removed from the LA
8. Staffing – only 1 authority in Scotland manages part of their Pension Fund in-house.

Investment Admin

9. Employment Costs – These costs may relate to part people at many levels of seniority. The basis of the charge made may vary from authority to authority e.g. based on timesheets, best guess etc.
10. Property Costs – Some authorities do not show a cost here. Some costs will be through a central support re-charge and included in the heading Fund Administration. The charge may not be a realistic figure of what it would cost to move to another property.
11. System Costs- again there can be a great variation in the charging policy. Dedicated systems should be quite easy to charge to the Pension Fund; however, if a system is used by several functions, method of charging can be variable across authorities.
12. Supplies & Services – some costs may be a direct charge to the Fund whilst others may be charged to e.g. Finance and then go through a recharge system.
13. Administration Costs – this may be a central support charge and may pick up a disproportionate split. Each Council may have a different method of calculating this.
14. Payments to other bodies – each authority has differing views on the level of involvement it has with other organisations e.g. in the area of Corporate Governance, or in voting etc
15. Fund Administration – see 12 above

Investment Management Costs

16. Employment Costs – Only one authority carries out investment management itself and this is on a passive basis for part of their portfolio.
17. Investment management fees – Direct fees are generally calculated as a percentage of the value of the assets being managed, on a sliding scale. However, performance related fees are becoming more common with outperformance above a certain level being rewarded with a higher fee. Some performance fees are capped. There is also the issue of pooled vehicles which do not have a clean fee and disguise the actual cost of running the money by altering the value of units or selling units. Private Equity poses another problem as very often you have to pay a fee on the commitment of an investment, even though the investment can be several years away. Also, some funds have received rebates of fees due to poor performance; also, some Councils accrue fees to the year they pertain, whilst others just ensure that there are 4 quarterly fees in each set of accounts.
18. Performance – Each fund has a customised benchmark, with a performance target related to this benchmark. That means that every fund is trying to achieve something slightly different from the next one. Therefore, what the fund manager is trying to achieve will be different – they are being sent different messages with regard to risk and tracking error. Therefore outperformance for one manager for one fund may be underperformance for a different fund with a different objective.

Appendix 4 – Current investment managers and mandates

Summary of Investment Managers and Mandates

	Multi asset	UK equities	Overseas / global equities	Bonds	Property	Alternatives
Dumfries & Galloway		LGIM(p)	Franklin Templeton Alliance Bernstein	Aberdeen Asset Management	RREEF	FX Concepts
Strathclyde	LGIM(p)	Gartmore (SC)	Baillie Gifford Capital International Genesis (EM) JP Morgan Alliance Bernstein Edinburgh Partners Invesco Lazard	PIMCO Threadneedle	Aberdeen Asset Management	Pantheon Partners Group Milennium Record
Strathclyde No 3	Schroders			LGIM (LDI)		Ruffer
Falkirk		Schroder	LGIM Newton Aberdeen Asset Managment	Baillie Gifford	Schroder	Standard Life Wilshire
Fife		BlackRock (p)	Alliance Bernstein Baillie Gifford Lazard	Henderson Global Investors Western Asset Management	ING	
Scottish Borders		Baillie Gifford UBS (p)	UBS	UBS	UBS	
Lothian		In house LGIM	State Street (p)*x2 Baillie Gifford* Aberdeen Asset Management* Franklin Templeton Lazard LGIM(p)	In house Rogge	Standard Life	In house JP Morgan Record Bisset
Lothian		In house	Baillie Gifford	Baillie Gifford (x2)	Standard Life	
Lothian		State Street (p)	State Street (p)*x4	State Street (p) x2	Schroder	
Aberdeen	State Street	BlackRock	Aberdeen Asset Management Baillie Gifford	Barings	Aberdeen Asset Management	HarbourVest Standard Life
Highland	LGIM(p)		Alliance Bernstein Baillie Gifford	Fidelity	Schroder	
Shetland	BlackRock(p)				Schroder	Record
Tayside			Baillie Gifford Fidelity Alliance Bernstein	GSAM Fidelity	Schroder	
Orkney	Baillie Gifford					

Appendix 5 – Governance question responses

A series of questions relating to governance were identified as requiring answers as part of this stage of the project. We outline below the questions and our responses.

28 Governance questions

1. Are there any associated costs with changing the existing LGPS elected member framework to another model(s)?

   Costs will be incurred changing to an alternative model, with the level of costs depending on the model adopted. Over and above the costs associated with any rationalisation of the actual investments and personnel involved with the day to day management and administration of the pension schemes, costs would need to be incurred which could potentially include legal costs if changes are required to the existing regulations and/or operating framework.

   If an independent management board model is adopted, costs would also be incurred covering the setting up and establishment of a board and executive.

2. Are there any associated costs with maintaining the existing LGPS elected member framework?

   It is not envisaged that additional costs to those that are already being incurred will be required if the decision is taken to retain the existing LGPS framework. However, from the discussions we have had with representatives of each of the administering authorities, a number of schemes recognise the need for taking external advice given the changing economic and market environment and the call for accountability and transparency.

3. Are there any associated costs with extending the Board(s) to include third parties?

   If the decision is taken to extend the Boards to include representation from third parties, there may be additional costs associated and the extent of these costs will depend on the external representation.

   If the decision is taken to extend the representation to other participating employers or admitted bodies, the additional costs would be minimal given that Board members are not paid and are only reimbursed for expenses. However, if the extension goes beyond to include independent professional advice, the costs will be higher.

4. What are the benefits and dis-benefits of operating within the existing LGPS elected member framework?

Benefits	Dis-benefits
• No requirement for change • Direct accountability to tax payers of the administering authority	• Limited scope for representation from participating employers and admitted bodies (with the exception of Highland where representation from Western Isles Council) • Whether members of the Boards have the required expertise to understand the increasingly complex environment • Turnover of membership of the Boards

5. What are the benefits and dis-benefits of operating out-with the existing framework?

Benefits	Dis-benefits
• Greater compliance with the proposals included in the Hutton Report • More straightforward to get non-elected representation onto the Boards – assuming the legislation can be amended	• Distancing the assets from the underlying councils even further than is currently the case given that currently the assets of the funds are owned by the council of the administering authority • Lack of accountability if the operating structure is not carefully/properly constructed

6. What are the risks of maintaining the current LGPS elected member model? How could these be mitigated?

Risk	Issue	Mitigation
Key man risk	Currently across the eleven councils, responsibility for the day to day management of the schemes lies with a limited number of individuals. If these individuals leave or retire in the near future, there is the risk that a considerable amount of local knowledge and expertise will be lost – a case in point being the turnover of staff for the Scottish Borders scheme.	Ensuring succession planning in place Existence of local authority pension officer groups to provide support and assistance
Knowledge and understanding by officers and members	With the growing complexity of investment markets and the changes to the local government pension landscape, there will be a requirement for schemes to consider more complex products and strategies	Appropriate training Greater use of external expertise

7. What are the risks associated with changing to another model(s)? How could these be mitigated?

Risk	Issue	Mitigation
Wrong model	The wrong model is adopted or implemented and the expected benefits fail to materialise	Taking appropriate external advice Ensuring wide consultation with all stakeholders during the design phase
Legal challenge	Whether the existing legislation would allow the implementation of the proposed model	Take appropriate legal advice and ensure wide stakeholder consultation
Lack of stakeholder support	Administering authorities do not support the change	Ensure wide stakeholder consultation
Conflict of interest	Members of the Board do not take into account the interests of all members	Appropriate training for all Board members Defined terms of reference for board members Greater transparency of the operations of the new Board(s)

8. What legislative changes would be required if the framework were to include non-elected members?

Legal clarification has been sought from SPPA who have confirmed that authorities currently have discretion to include non-elected members with full voting rights on their pensions committees.

9. How would the role be delegated to the body (1, 2, or 3 administering bodies)?

We believe that the existing regulations could be used but would need this to be confirmed by the SPPA depending on the structure of the revised model / framework.

10. What role would the SPPA have in a new governance framework?

It is not altogether clear what role the SPPA would fulfil in a new governance framework – to an extent this would depend on the structure of the new framework. A key issue, though, would be that the role would need to be clearly defined, making sure that there are no conflicts of interest – for example the role could be either to act as an independent policy body, providing guidance and assistance on areas such as legislation, or as a potential provider of services.

11. How could it be ensured that the appropriate level of experience for board(s) members involved in Investment Strategy is identified, recognising the need for a step change in the experience and technical expertise of the board(s) and the requirement to commit significant amounts of time to this activity?

There are a number of ways to ensure that the appropriate level of expertise for board members is available:

- More formalised training of both the members and the supporting officers;
- Defined terms of reference for board members;
- Greater use of external resource and, if more than 1 fund, ensuring an appropriate forum exists for the sharing of resources and intellectual capital;
- Review and oversight by an independent body, assessing and challenging the decisions taken on an ongoing basis.

12. What mechanisms are required to allow for timely decision-making?
Consideration needs to be given to the current governance arrangements and what changes – both in terms of structure and potentially legislation – would be required to allow for more timely decision making.

13. What reporting mechanisms from executive officers are required?
As above.

14. Are there any benefits or dis-benefits associated with accountability in the current and potential changed environment?
See responses to questions 4 and 5.

15. Can accountability be extended to a wider constituent of employers, specifically the wider 32 Councils/other schedule employers? What are the benefits/dis-benefits in this?
While in theory accountability could be extended, this would raise issues over the effectiveness of the day to day operations. To ensure timely decisions the governance structure would need to allow delegation of certain decisions to smaller, more focused sub committees.

Benefits	Dis-benefits
• Promote greater sense of ownership and involvement	• Risk of losing sharpness and clarity in decision making

16. Are there benefits or dis-benefits associated with trustee and officer knowledge and opportunities to enhance understanding of the running of a complex pension fund(s)?

Benefits	Dis-benefits
• Accountability to local council tax payers	• Turnover within committee membership linked to political calendar

17. Are there any risks relating to ensuring successful delegation?
To allow and ensure successful delegation there would need to be a strong governance and reporting framework in place, with clear terms of reference documented and monitored for the sub committee.

18. Are there any risks in changing the process of decision making?
While there are always risks associated with a change of process, it should be possible to mitigate these by ensuring appropriate governance structures are in place and any delegated decisions are handled by individuals or committees with the relevant set of skills.

19. Is there a risk that a changed environment will have insufficient accountability?
This should not be a risk if the environment is correctly structured, is subject to wide stakeholder consultation during the design of the new environment and there is sufficient transparency to allow clear decisions to be made, monitored and assessed.

20. How will the decision be made as to who is responsible for making particular decisions?
This will depend on the structure of the board or framework introduced but with the overall board retaining responsibility and accountability for decisions delegated.

21. How will decisions be made i.e. what criteria will be used, over what timescale?
This will depend on the agreed terms of reference for any new board or modified elected member framework

22. What control and compliance procedures require to be put in place?

Clear terms of reference for any Boards or sub committees will need to be agreed along with processes and procedures for monitoring and reporting of the activities of the various groups. As part of this process there will need to be agreement over how any reporting from the monitoring is communicated to members and the means by which this is achieved.

Overall consideration should also be given to the extent to which the processes and procedures and adherence to them are independently audited or verified.

23. Are there any benefits or dis-benefits to having political representation on the board(s)?

Benefits	Dis-benefits
• Accountability to council tax payers	• Potentially excludes wider representation

24. What are the associated political risks/issues in ceding responsibility from councils to the new body('s)? How could these be mitigated?

One of the key risks from passing responsibility from the councils to the new body(s) will be the accountability to council tax payers and in this respect we would advocate that any delegation is seen as sharing rather than ceding. In determining the appropriate structure, care would need to be taken to ensure that there is accountability to the wider stakeholders. To help in this respect there would need to be clear terms of reference documented and an appropriate reporting framework. In this regard there could be a role for an entity such as Audit Scotland to ensure adherence to the terms and guidelines.

25. What is the risk that councils would feel remote from the new body('s) and be concerned about loss of control? How would this be mitigated?

There is a major risk that the councils will feel removed and in this regard it is essential that there is wide consultation in the design and implementation phase. As part of any ongoing governance arrangement, consideration needs to be given to how effective consultation takes place and that there is accountability back to the councils for major decisions taken.

26. What are the precise legal arrangements for establishing a new larger body('s) and statutory position of executive officers?

SPPA are unable to advise of precise legal arrangements until a proposed new model is agreed and details set out for them.

27. What changes to investment regulations are needed to meet future efficient investment management strategy needs?

To allow more efficient investment management strategies in future, consideration needs to be given to removing the current restriction on the use of over the counter derivative products (in particular use of swaps – although these are allowed within a pooled fund structure). The other restriction that needs to be changed is the restriction that limits the amount to 35% of total assets that can be invested in a single life policy or contract - this is particularly required if there is to be greater use of passive management where the exposure is achieved through pooled funds.

28. What will be the framework for political representation/council representation on the new board(s)?

The proposed design of any new board(s) has not been considered yet, however we recommend that approval is given to develop this as part of the next phase of work.

Appendix 6 – Administration case study

Case Study: Cumbria County Council

Scenario

In 2000, Cumbria County Council ("Cumbria") took the decision to outsource their pensions administration services through a competitive procurement process. Capita, a leading private sector pensions administration service provider, secured the contract and Cumbria's administration services and staff were transferred to Capita in 2001.

In 2010, with the Capita contract due to end as at January 2011, an evaluation of future options was carried out with the following 2 principal objectives:

1. A step change improvement in quality of service; and
2. A move from current bottom quartile administration costs to top quartile

The options that were considered included:

- Bringing administration services back "in house"
- Continuing to outsource services to a private sector provider
- Entering into a shared service arrangement with another Local Authority

Solution

After detailed research and careful consideration, a decision was taken to enter into a shared service arrangement with Lancashire County Council ("Lancashire") for the provision of future pensions administration services. These services cover Cumbria's c. 43,000 members of the LGPS and the Fire Pension Scheme as well as the provision of ancillary functions relating to the Teachers' Compensation Scheme.

The main conclusions of Cumbria's evaluation of the available options were:

- Bringing administration services back "in house"
  - High set up costs (including IT procurement)
  - Ongoing costs were deemed expensive
  - Not a "core service"

- Continuing to outsource services to a private sector provider
  - Capita costs were bottom quartile
  - Service levels from Capita were considered poor
  - Lack of understanding by private sector providers of LGPS
  - Concerns around future change control costs of implementing benefit structure changes
  - Costs and timescales of conducting a full procurement exercise

- Entering into a shared service arrangement with another Local Authority
  - From the range of large authorities considered, Lancashire demonstrated a track record in providing a high standard of services
  - Costs from Lancashire were top quartile
  - Flexible working relationships and experience of LGPS administration

As a result, Cumbria's pensions administration services were transferred to Lancashire with effect from 1 February 2011. The arrangement between Cumbria and Lancashire is governed under the provisions of s.111 of the Local Government Act 1972 and s.2 of the Local Government Act 2000 and obligations under s.3 of the Local Government Act 1999.

Implementation of the new arrangements was completed successfully within 6 months, including all data transfers and transfers of previously outsourced staff from Capita. Details of how the arrangements between Cumbria and Lancashire will operate are set out under a Collaboration Agreement which includes details on services, key performance indicators, costs, and agreed principles on ways of working.

Outcome

The services provided by Lancashire to Cumbria are comprehensive and include:

- A fully managed service covering all aspects of pension administration for all Scheme Members from new starters to retirements through to a pensioner payroll facility;
- Provision of a 24 hour customer service centre and a dedicated web link allowing electronic interaction for both Scheme Members and their employers;
- A dedicated Pensions Liaison Officer and annual on site surgeries in each district council area within the county of Cumbria and at least one annual conference/event in Carlisle;
- Annual newsletters to all Scheme Members in respect of each Scheme under administration;
- Quarterly reporting of key performance indicators showing performance achievement relative to service standards and performance measures; and
- A full annual report to Cumbria's Head of Technical Finance encompassing overall performance, volumes of processing undertaken over the year as well as an update on events and activities over the year.

Although only relatively recently implemented, Cumbria are already experiencing service level improvements and significantly improved management information flows.

Acknowledgement

We are extremely grateful to Fiona Millar, Head of Technical Finance at Cumbria County Council, for giving up her time to inform us about Cumbria's recent experience in reviewing future administration options and the implementation of the solution identified.

Appendix 7 – Glossary of investment terms

Active Management

Approach to investment management which aims to outperform the return of a market index or benchmark by using expertise to select assets. (*Also see passive management*)

Alternative Investments

Investments which do not fall into the mainstream asset classes (i.e. equities, bonds and cash). Examples include property, private equity, hedge funds and commodities.

Benchmark

Measure which a portfolio's actual performance is compared against.

Bond

Certificate of debt issued by a Government or company which promises a series of regular payments on specific dates and a payment at the end of the term.

Basis Points

1/100 of 1 percent i.e. 100bp = 1%

Custodian

Organisation which is responsible for the safekeeping of assets on the behalf of an investor i.e. recording transactions, income collection and trade settlement.

Enhanced Index

An approach to investment which aims to outperform an index to a lesser extent than traditional active management.

Equities

Shares in a company.

Fund of funds

A pooled fund which invests in other funds rather than directly in underlying securities.

Illiquid

Assets that cannot be quickly converted to cash at a predictable price.

Index-tracking

Aiming to match the performance of a particular market index.

Liability

A financial obligation of payment i.e. members' pension benefits for a pension scheme.

Net of fees

After payment of fees.

Passive Management (or index tracking)

Approach to investment management which aims to replicate the return of a market index or benchmark. (*Also see active management*)

Performance Fee

Investment management fee determined by the degree of performance relative to an agreed benchmark.

Pooled Fund

Grouping the assets of many investors together to be collectively managed. (*Also see segregated funds*)

Segregated Fund

An investment portfolio for a single investor where assets are held separately to those of other investors. (*Also see pooled funds*)

Unit Price

Value of a single unit in a pooled fund.