Private and Confidential

Scottish Local Government Pension Scheme Advisory Board

Review of the Structure of the Scottish Local Government Pension Scheme

Introduction

A key part of the Scheme Advisory Board's (SAB) workplan is to carry out a review of the structure of the local government pension scheme in Scotland. At its meeting in May 2016, the SAB agreed (Annex 1) to the establishment of a working group to undertake this work with the following remit:

- To develop a project plan for the structure review that aims to deliver an options appraisal for the SAB to consider.
- To commission research and advice from appropriate experts to inform the review.
- To report progress to each SAB meeting and submit the completed options appraisal to the SAB for the February 2017 meeting.

Specific terms of reference were agreed at the September 2016 meeting (Annex 2).

This report therefore presents the completed options appraisal and explains the work that has been done to arrive at this.

Four main options have been considered:

- Status quo of eleven funds in Scotland.
- Retain the eleven funds, but with closer collaboration.
- One or more common investment pools.
- Merge the funds into one or more new funds.

The working group commissioned two external reports. The first is from the pension consultants Mercer (Annex 3), primarily to analyse the available data. The second report (Annex 4) is from Iain Clacher of the University of Leeds, to provide a wider academic and outsider perspective of pension structures.

The structure of this report starts with some context, including the background to the structure review of the Scottish Local Government Pension Scheme (Scottish LGPS), how it is currently organised and the challenges it faces. The report then explains why understanding scale is important to the review, drawing on international studies as well as the available data in Scotland and issues such as infrastructure investment and engagement. Despite the global movement to scale this part of the report also highlights some of the delivery challenges change brings. Finally, the report sets out our findings on the four options and conclusions. There is an executive summary of the pros and cons of each option in Annex 6.

The remit was to produce an options appraisal; therefore there are no recommendations.

Membership of the SAB working party

Hayley Barnett	COSLA – SAB Joint Secretary
Sharon Dalli	Police Scotland
Richard McIndoe	Strathclyde Pension Fund
Clare Scott	Lothian Pension Fund
Jonathan Sharma	COSLA – SAB Joint Secretary
Brian Strathie	Scottish Water – SAB member
Dave Watson	UNISON Scotland – SAB Joint Secretary

Context

Background

The Scottish LGPS is Scotland's largest pension scheme, providing pensions to around 163,000 pensioners, formerly employed by councils, scheduled and admitted bodies. There are some 218,000 contributing members to the scheme and a further 125,000 deferred members. The scheme is funded by employers and members in accordance with statutory regulations and is delivered by 11 administering authorities, with managed assets exceeding £35bn.

The average asset allocation in Scottish funds is 66% equities, 13% bonds and 21% in alternatives including property. Investment returns have averaged 1.2% over the last year and 8.1% per annum over the last 5 years.

The Scheme Advisory Board (SAB) is responsible for advising Scottish Ministers on the scheme. Each administering authority has a pensions committee and is assisted by a pensions board, established under the governance provisions of the Public Service Pensions Act 2013 and subsequent Scottish regulations.

The background to this review is set out in a paper to the SAB in May 2016 (Annex 1). The Scottish Government and COSLA previously commissioned a review from Deloitte's, published in 2011, which considered a number of structural options. UNISON Scotland also commissioned a report from APG, which focused on the potential economies of scale in asset management. In England and Wales, the Treasury has driven the pooling of investment funds into six pools, typically with over £25bn of assets under investment.

In Scotland, the SAB's initial focus has been on improving data collection[1], as an essential starting point for a structural review. The SAB has also considered a paper and presentation on the transparency of investment costs. These issues are also reflected in the recent interim report[2] of the Financial Conduct Authority (FCA) on asset management.

Challenges facing the Scottish LGPS

Any review of the structure of the Scottish LGPS has to start with an understanding of the challenges facing the scheme and pensions more broadly. These are outlined in Annex 5.

The new governance arrangements for the Scottish LGPS means there is a greater focus on cost transparency and performance. To this we can add volatile markets, lower economic growth and Brexit uncertainty. Lobby groups are concerned about specific classes of investment such as fossil fuels and there is an increasing political focus on infrastructure investment.

Active membership of the Funds is maturing and this is likely to continue due to budgetary constraints across the public and charity sectors. Despite this, membership of the Scottish LGPS is increasing, in part due to auto-enrolment. Scheme administration is more complex due to changes in Scottish LGPS regulations with three different schemes and transitional arrangements. Reduced pension taxation allowances and new pension freedoms provide added complexity.

Administering Authorities manage large numbers of employers, subject to increasing change. This includes national organisations that have staff in a number of different funds. Lower yields, which are not taken into account in the cost-cap mechanism, continue to put pressure on employer contributions and the ongoing affordability. There is an increasing requirement to assess financial strength of employers to ensure liabilities are honoured and reduce the risk of liabilities falling on other employers.

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[1] SAB Annual report 2016 - http://lgpsab.scot/sab-annual-report-201516/

[2] FCA Asset Management Market Study 2016 - https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf

For scheme members there is confusion with regard to freedom and choice, the impact of the state retirement age and the end of National Insurance contracting out. Taxation concerns with regard to annual and lifetime allowances and lower real wage growth may drive 50:50 decisions or contemplation of departure from the Scottish LGPS. There are mixed messages with regard to ongoing affordability of Defined Benefit (DB) pension schemes in general. While investment performance doesn't directly impact on the cost cap mechanism, trade unions are concerned over the impact higher employer cost could have on wages and job security as well as access to the scheme for employees in admitted bodies.

Due to the complexity of pension fund issues, specialist staff are needed. Recruitment of such specialist staff can be difficult due to council terms and conditions, particularly for investment staff and there can be problems in attracting staff to more rural areas. Changes to the investment arrangements for the LGPS in England and Wales could increase competition for investment and legal staff. Staff in smaller Administering Authorities often have responsibility for other council duties as well as those related to their pension fund. Resources for the pension fund can be impacted by broader council developments.

These challenges mean that administering authorities have to strengthen and manage enhanced governance arrangements as well as balancing the perception that funds' investments are seen as public money and the requirement to manage them in line with fiduciary responsibilities to members and employers. They have to assess and monitor increasingly complex investment options, ensuring transparency of all costs and focus on being an active shareholder to enhance long-term value and ensuring transparency.

The funding challenges mean that reducing cashflow is an increasingly important consideration in setting investment strategy. Funding, investment options and managing exits from funds for certain employers adds to this complexity – as well as assessing the options available to multi-fund employers to rationalise the employer contribution rate and membership across funds. As highlighted in the recent GAD Section 13 Dry Run Report (February 2017), there are a number of presentational inconsistencies which are summarised in Annex 5.

Pension administration has to increase the focus on the quality of membership data and develop a standardised approach to management information from administration systems. In particular for reconciling Guaranteed Minimum Pensions with HMRC as a consequence of ending the contracting out of the State Pension Scheme and communicating complex benefits to members.

Understanding Scale

There is a global trend towards scale in pension funds driven by concerns about value for money in pension fund management and scale, on balance, seems to be a significant driver of cost reduction. The academic report (Annex 4) highlights examples from across the world, referencing studies in the USA, Australia and the Netherlands. The report also gives three case studies from Australia, the Netherlands and Canada to illustrate how this operates in practice. The report concludes:

"Overall, the academic evidence on costs and fees seems to support the premise that there are cost savings with scale, and that this can occur on both the administration and investment side."

This is reinforced in the Mercer report (Annex 3), however, they point out that it is difficult to calculate a tipping point for economies of scale.

It is therefore likely that cost savings could be generated if there was to be a significant scaling up of pension fund assets as this increases the bargaining power of the Scottish LGPS. The duplication across funds in terms of administrative, governance, advisory, and fund management costs, and lack of scale in most of the Scottish LGPS funds, would suggest that aggregate fees across schemes are too high. Even small reductions in investment manager fees are significant. For every basis point, i.e.0.01%, reduction in fees an annual saving for the Scottish LGPS would be c£3.5m, all else being equal.

Scale is also a driver towards the development of in-house teams as a means of controlling costs as illustrated in the Canadian example in the academic report and elsewhere. In Scotland the Lothian Pension Fund has significantly increased the amount of in-house investment it undertakes. This fund outperformed the CEM benchmark cost for a fund of comparable size and asset strategy.

The Mercer report also highlights this development, stating that while Lothian alone is not statistically significant, it is something that should be explored further. They point to a global study (MacIntosh and Scheibelhut 2012) that found that for every 10% increase in internal management, there was an increase of 3.6 basis points in net value added. This was driven by lower costs, but relied on recruiting a high quality internal team. The OECD Large Pension Fund Survey (2015) also highlights a trend towards insourcing in large funds, although again recognising the importance of attracting talented professionals.

Infrastructure

Another advantage of scale is the ability to make direct and co-investments in large infrastructure projects. The Mercer report includes a case study on infrastructure investment that highlights that this constitutes just 1.5% of assets in Scotland, although this figure is likely to be higher in the next published data.

Again the academic paper points to international examples. These investments, when suitably structured, work well for pension funds as they have predictable cash flows that are often index-linked, and have a longer life, which is good for matching pension liabilities. However, what constitutes a suitable infrastructure investment for a pension fund needs to be carefully set out and safeguards put in place to prevent governmental or local issues driving investment to projects where there is no financial return to the pension fund. Any such investments simply weaken any pension fund and increase the cost of member benefits.

The Mercer report points to the costs and additional resourcing involved as being prohibitive for smaller funds. These funds tend to use fund of fund arrangements that can be more expensive. Mercer suggest £2bn (5% of funds) is the necessary scale to have a rolling program of different investments managed internally. They also point to the potential for collaborative infrastructure platforms, citing the Australian IFM model and others.

Engagement premium

The Mercer report highlights another benefit of scale that they call the engagement premium. This ranges from the appointment of specialist managers to deliberately choosing companies with a depressed share price as a target for engagement.

Mercer point to studies that show active engagement by pension funds at worst leads to no downside to returns and at best leads to an uplift of 2-4 per cent in returns in the year following engagement activity. CalPERS in the US and Hermes in the UK are well known devotees of active engagement.

Scottish data on scale

The Mercer report looks at the data available on Scottish funds in relation to scale. They warn that we should not form too strong a conclusion on the basis of data spanning only 15-16 funds and covering just the last 1 and 5 years. However, they find no clear link between Scottish LGPS fund size and investment returns. Scottish funds also have a low cost base, although they would expect fee savings to be leveraged from scale in Scotland, while warning that a focus solely on costs has the potential to destroy value.

They show that the average performance of the Scottish funds' active global equity managers was 16.2% p.a. compared to a passive return of 16.4% over the five years to 30 September 2016. They also highlight a wide variation in returns between funds ranging from 11.6% p.a. to 21.2% p.a.

Mercer report that the Scottish funds have added value from active management. This has been calculated as 0.6% over the last year and 0.7% p.a. over the past five years. However, as they concede, we have limited data on costs and fees until the new reporting template is in operation. The benefits of active over passive investment have been challenged in the recent FCA report, which post-dates the Mercer report. Either way, it is likely that a balance between the two is likely to feature in the investment strategy of all the options for change.

Delivery challenges

Delivering scale could be met with resistance and centralisation is a sensitive issue within local government. While merging funds could lead to some job losses; if there were to be sufficient in-housing of investment functions then this is likely to increase employment as more investment and supporting functions are in-housed rather than outsourced. There is the potential for some administrative savings from scale, but this is not a major factor in evaluating the options for change.

However, pension funds, are not analogous to other areas of centralisation that have been more contentious e.g. Police Scotland. Administering authorities largely set strategy and undertake some monitoring, with the day-to-day activities around key areas such as investment and risk management being outsourced to external providers e.g. the fund management industry. As a result of largely national wage settlements, all of the pension funds have the same goal, which is simply to pay member benefits in the most cost effective way. There is not, at least at a high level, an issue of localism Vs centralisation that emerges from pooling; it is simply a question of investing moneys in the most cost effective way to secure member benefits.

Any restructuring would take time and cost money. Moreover, the gains to any long-term strategic shift in the operation of the Scottish LGPS are likely to emerge over a number of years rather than immediately or in the short-run. It will also be important to get the right structures, regulations, and people in place. The governance of any pool is crucial and appropriate employer and employee representation will help ensure that the fund is run for the benefit of members and employers.

The options for the Scottish LGPS

As we set out in the introduction there are four main options – status quo, cooperation, asset pool, and merger. The academic paper summarises each of these options below in relation to their advantages and disadvantages in terms of investment performance and governance. In addition there is further detail in Section 4 of the Mercer report. Annex 5 includes funding considerations for each of the options.

Status Quo

The first option for the Scottish LGPS is to do nothing and to maintain the status quo. As such, there would be 11 funds and 5 sub-funds of varying scale. From an investment perspective this is likely to mean that inefficiencies will exist across the Scottish LGPS as most of the funds will not achieve the benefits of scale that have been documented across a number of countries including the UK.

The consequence of this is that some schemes will cost more and be a greater expense to local authorities than they otherwise need be. Over the long-run, such cost inefficiencies could be considerable and thus require higher contribution rates putting further pressure on local government and employer budgets.

With respect to governance, for many of the smaller schemes, there is an issue of focus. Many of the smaller schemes do not have a dedicated pension team and it is often the case that the administration of the scheme is only part of someone's job. This is not optimal and may present a key-person risk to the running of the scheme.

In looking at oversight, the current structure is complex and it is likely that there are varying levels of governance across schemes. The delegation of investment mandates, performance targets, and an understanding of costs and fees is unlikely to be optimal. However, the status quo option will maintain a local connection with respect to oversight and strategy, which may be more difficult to keep or may even be lost if a more centralised asset pool or merged fund were to be created.

Cooperation

Cooperation across schemes could lead to some efficiency gains. There are already examples of this. On the investment side, the case of Lothian and Falkirk allowed for Falkirk to collaborate with Lothian and leverage some of the expertise and scale within the Lothian fund. Similarly, some cost efficiencies could be gained if broad mandates e.g. UK passive equities were to be invested as one large block rather than as separate mandates across a number of funds.

With respect to the governance of such arrangements, if the case of Lothian and Falkirk were to be followed as a template, the current structure of governance would be likely to continue, and Pension Committees would have to coordinate more with respect to the delegation of investment mandates. While this is relatively straightforward for common investments such as passive equities, it is more difficult for alternatives such as infrastructure. For example, if investment to infrastructure is only a small part of the investment strategy of a number of schemes, the process of increasing the strategic asset allocation to infrastructure to allow increased investment to occur is likely to be a slow process.

This means that smaller schemes may not be able to co-invest in the same way as larger schemes, or that some investment opportunities are missed as finance cannot be coordinated in time. If this were to be the case, there is the potential for a knock-on effect to larger schemes, as they are unable to raise the funds, and so there is the risk of reputational cost. Ultimately, there are some gains to be had from cooperation, but these are likely to be limited by virtue of extant governance structures. However, the local governance that currently exists would remain in tact, as mandates would be directed by the Pension Committees of the individual funds.

Asset Pooling

Asset pooling would be a significant shift to the way in which the Scottish LGPS undertakes investment decision-making. From an investment perspective, if there were to be an aggregated pool, this would result in a centralised pool with circa £35bn of assets under management. However, the assets and liabilities could still be allocated by employer, to ensure that employers would still be liable for the pension obligations that they have accrued, for any deficit that they are liable for currently, and for any new benefits that are promised.

If there were to be an effective asset pool, then it is likely that there would be significant cost savings resulting from scale. In addition there would be large initial transitional and set up costs including FCA authorization. Moreover, this scale could enable the in-housing of the majority of the investment activities of the fund, which is likely to create significant cost efficiencies as well as allowing for a more dynamic investment strategy. As the Lothian case shows, it is possible for there to be effective structures put in place that allow for more efficient investment to take place without having to rely on the external fund management industry.

From a governance perspective, this could lead to a more transparent and consistent governance model. While there are a number of possible structures that could occur, the most likely structure would be one where each fund's Pensions Committee would set broad asset allocation for the investment of assets.. The day-to-day management of the investments would then be delegated to the pool. Similarly, there would still be a scheme advisory board as stipulated in The Public Service Pensions Act 2013. This would still have employer and employee representation and provide advice on the administration and management of the pool as well as providing some sort of support to a Pensions Board that would have oversight responsibilities to ensure the fund was run in accordance with applicable laws and regulations.

Governance of the pool would be critical to ensure accountability. The role of the local Pensions Committee would be to focus on investment strategy and funding decisions. Local funds would be more focused on the performance and accountability of a centralised pool, and it is likely that they would exert a high degree of scrutiny on the performance of the pooled assets.

Merger

The final scenario is for the Scottish LGPS to merge and so assets and liabilities sit in one fund. Within the local government setting, a merger is possible as salaries and benefits across the country mostly result from national wage agreements. If there were to be a merger, then this is simplest where schemes are approximately equally funded. However, it is unlikely that such a scenario will exist over the coming years given current deficits and the current investment environment. In merging the funds, the assets and liabilities still have to be allocated by employer, as employers would still be liable for the pension obligations that they have accrued, for any deficit that they are liable for currently, and for any new benefits that are promised.

In merging the funds however, there are likely to be additional gains from better risk-pooling and risk-management, as well as the potential gains on the investment side that have been discussed with pooling of scheme assets.

The merging of the Scottish LGPS is likely to have the most far-reaching governance consequences. Governance would no longer be a local government function and would be the responsibility of a quango. Although there would be local government representation on The Pensions Board, the treasury function of local government would no longer have direct involvement in pensions. A merged fund would have a clear governance structure with strategy being set by a Pensions Committee and oversight being provided by The Pensions Board, however, there would be a significant disconnect between the employer and the scheme and local engagement.

It is worth noting that this is not the only structure. For example, there could be a lead authority or a joint board. However, it is not clear that effective decision-making would result. In this structure, problems of coordination and disagreement with respect to strategy are likely to emerge, as there will be a disparate range of views around the table motivated by a number of factors. Further, it is not necessary to have both a pensions committee and a board as these could be merged.

Conclusion

As examined above, the Scottish LGPS has four options. First, do nothing and maintain the current structure. Second, look to do some more co-investment or sharing of services. Third, pool scheme assets in a manner analogous to the pooling of LGPS assets that is ongoing in England and Wales, and fourth undertake a wholesale merger.

Much of the debate on this issue in the UK, reflected in international experience, has been around the potential benefits of scale in pension management. The debate essentially comes down to the benefits economies of scale and expertise, as against transition costs and the impact on local governance.

Whichever options are adopted this would need to take account of the recommendations in the Scottish Public Service Pensions Governance Review.

The SAB is now being asked to consider the options appraisal and to offer views on taking the review forward. It is important to stress that that the purpose of the work done so far is to present options for further consideration and not to provide definitive solutions.

Scottish Local Government Pension Scheme Advisory Board
Structure Review Working Group
February 2017

Annex 1

Scottish Local Government Pension Scheme Advisory Board
May 2016

Structure Review

Introduction

The SAB workplan includes the action; '*Following from the data collection exercise, to complete a review of the structure of the Scottish LGPS*.' The Deputy First Minister made a specific reference to this item in his letter approving the workplan.

This paper sets out the background to the review and how we might take this forward.

Deloitte Review

In 2007 COSLA initiated the 'Pathfinder Project' to identify the potential for cost savings and operational efficiencies through the adoption of shared services within the SLGPS. They appointed Deloitte to undertake the project. In 2008 following discussion with the Scottish Government, the scope of the project was broadened in recognition of wider opportunities to rationalise and improve the SLGPS.

Following the Phase One report, a second phase of research was agreed by the Improvement Service, Scottish Government and COSLA, with input from pension officers from the 11 funds and SPPA. That report was published in 2011.

The report considered a number of models including retaining the current structure and merging into one, two or three larger host funds. While Deloitte identified a number of key risks in the current structure, they concluded that the savings in investment management fees would not be significant enough to justify, in cost terms alone, merging funds. They reached a similar conclusion in relation to an improvement in investment performance. They did recommend less active investment management and pointed to the benefits, particularly for small and medium sized schemes, of shared technical advice.

In relation to administrative costs, the report found that costs per member in Scotland compared favourably with funds in England and Wales. However, based on the experience of shared services between Cumbria and Lancashire they recommended further consideration of a single operating model and a common administration system – rather than formal administrative mergers.

APG Review

In light of increasing awareness about investment fees and performance, UNISON commissioned the Dutch pension group, APG, to under a similar review of LGPS pension funds across the UK, including Scotland. They took the data on 101 funds over the period 2001 to 2009 and modelled the impact of fund mergers.

They concluded that investment expenses and administration costs decline when the size of fund increases and that larger funds consistently achieved higher investment returns. They also draw upon international studies that show substantial positive economies of scale in asset management.

APG's simulation for one fund in Scotland indicated average annual savings in investment management costs of £7m. They also concluded that improved investment performance could have led to £772m of additional assets for Scottish funds.

Audit Scotland

In February 201, Audit Scotland reported on the cost of public sector pensions in Scotland. The focus of this review was on the costs of benefits and associated contributions. It referred to the work being undertaken by Deloitte's, rather than duplicating it. They summarised the advantages and disadvantages, which essentially come down to economies of scale and expertise as against transition costs and the impact on local governance.

Pooling of investment funds in England and Wales.

The UK government initiated a consultation looking at the potential for merging or pooling of LGPS funds in England and Wales. While this initiative did not reach a conclusion, in October 2015 the Chancellor called for the assets of the 89 Local Government Pension Scheme funds in England and Wales to be merged into six 'British Wealth Funds', each containing at least £25bn of scheme assets. Scotland is not included because public sector pension regulation is devolved. If it was, with assets of over £30bn, it would be large enough to stand alone as an all Scotland pool.
The UK government believes the new pools will lead to economies of scale and improved ability to invest in infrastructure. It expects final plans to be in place by 15 July 2016. While most funds have joined a pool, the final shape of those pools and how they will be regulated are yet to be finalised. Governance arrangements are also unclear.

Even supporters acknowledge the costs of setting up new structures and transitioning assets. However, they expect pooling to provide significant cost benefits resulting from the large size and scale of the pools. These benefits include lower operational costs, zero cost crossing benefits (matching buyers and sellers at zero cost), lower execution costs and in many cases lower fees, all of which can be passed back to all investors. All else being equal, a reduction in costs should help reduce deficits and improve funding levels. However, ultimately market movements can impact deficits more than costs.

Progress in Scotland
The SAB agreed that our initial focus would be on improving data collection, as an essential starting point for a review. The initial work on that exercise was presented to the SAB's March meeting. This is an important step forward, while recognising that there is more to do to achieve consistent data.

In addition, board members have been circulated with a paper from UNISON that was prepared by the Federation of Dutch Pension Funds with recommendations on administrative and asset management costs. The SAB also received a presentation from Dr Chris Sier on transparency of investment costs.

Next Steps
From this brief overview the SAB will recognise that this is a complex exercise and not without controversy. The traditional approach would be to appoint consultants, consider their recommendations and then consult on the options. However, given the history of this issue it may be difficult to find a single consultancy that commands respect from all sections of the SAB.
We therefore recommend the establishment of a working group with the following remit:

- To develop a project plan for the structure review that aims to deliver an options appraisal for the SAB to consider.
- To commission research and advice from appropriate experts to inform the review.
- To report progress to each SAB meeting and submit the completed options appraisal to the SAB by December 2016.

Joint Secretaries
May 2016

Annex 2

Scottish Local Government Pension Scheme Advisory Board

Structure Review Working Group
Terms of Reference

Introduction
The Scottish Local Government Pension Scheme Advisory Board (SAB) is conducting a structural review of local government pension funds in Scotland. The background to the review is set out in Annex A to this terms of reference.

Working Group
A working group has been established with a remit to prepare an options appraisal on the future structure of local government pension funds in Scotland. The likely options include (but are not limited to):

- The status quo of eleven funds in Scotland.
- Retain the eleven funds but with closer collaboration (examples identified).
- Retain the eleven funds, but share administrative services.
- One or more common investment pools.
- Merge the funds into one or more new funds.

Research will be undertaken which will include an overview of the current structure, governance including staffing and the implications of the different options. The working group will then identify challenges and advantages in relation to each option. The review will be look at the key aspects of the service – Investment, Funding and Administration.

It is recognised that the Structure Review has governance implications for the Pension Funds. Any work on governance will therefore have reference to the Governance Review for Scottish Public Sector Pension Schemes and the working group will maintain close contact with SPPA with regard to this.

Following consideration of the options appraisal by the SAB, a consultation process will follow with all stakeholders before the SAB makes any recommendations to Scottish Ministers.

The group will submit the completed options appraisal to the SAB for its meeting in February 2017.

Group Membership
The working group comprises of the joint secretaries to the SAB plus two LGPS pension fund advisers and two employers' representatives.

Accountability
The working group reports directly to the SAB and will provide reports for each SAB meeting as the project progresses. The group will maintain a close working relationship with SPPA on the conduct of the Structure Review and will receive advice from SPPA with regard to Scottish Ministers' interest in the project.

Approach
The working group will meet on a monthly basis or more frequently as considered necessary.

The group is seeking to commission research and support for the project.

Joint secretaries
September 2016

Annex 3

Investment Research – Structure Review: Mercer - December 2016
(Attached)

Annex 4

Understanding Scale in Pension Funds: Iain Clacher, University of Leeds – January 2017
(Attached)

Annex 6

Executive Summary – Overview of Pros and Cons
(Attached)

What are the challenges facing LGPS Administering Authorities, Employers and Employees?

Political, Regulatory & Economic

- New governance arrangements including oversight by The Pensions Regulator, local Pension Boards and a national Scheme Advisory Board mean that Administering Authorities are facing significantly increased level of scrutiny. There is a greater focus on the transparency on costs and performance in such areas as data quality, member service, annual benefit statements and actuarial valuations are receiving increased scrutiny.
- With the specialist nature of the service, Committee and Pension Board knowledge and understanding is an ongoing challenge, particularly after elections when there can be turnover in membership.
- Economic growth in most parts of the world is reducing and yields on government bonds remain at historic lows. Yields have moved lower again following the Brexit referendum. Some investment solutions are increasingly complex and potentially more costly.
- Changes in LGPS Regulations mean that pension benefits have been accrued in three different schemes with various transitional arrangements. Benefits have different accrual bases (two final salary schemes and one career average) and different retirement ages (age 65, State Pension Age complicated further by Rule of 85 protections). Benefits are complex for members to understand and for Administering Authorities to administer. Reduced pension taxation allowances and new pension freedoms provide added complexity.
- Administering Authorities continue to receive large numbers of Freedom of Information requests and face ongoing lobbying from special interest groups regarding investments, e.g. fossil fuels, tobacco. More recently there is increasing political focus on infrastructure investment.
- Implementation of MIFID II requirements in 2018 could mean that Administering Authorities are classed as retail, as opposed to professional, investors. This could have major implications for investment options available to funds.

Fund Membership

- Active membership of the Funds is maturing. This is likely to continue as ongoing budgetary constraints across the public and charity sectors are expected to lead to further reductions in employee numbers and many admitted bodies do not offer LGPS membership to new employees. Auto-enrolment requirements could provide a balance to this.

Employers

- Administering Authorities manage large numbers of employers. Lower yields, which are not taken into account in the cost-cap mechanism, continue to put pressure on employer contributions and the ongoing affordability. There is an increasing requirement to assess financial strength of employers to ensure liabilities are honoured and reduce the risk of liabilities falling on other employers.
- Employers are increasingly in a state of flux, for example: mergers, changes of legal status, and insolvency.
- Different pension valuations for different purposes (e.g. IAS19, funding, cessation) often cause confusion and bring additional costs for employers.
- As employers seek to improve efficiencies and economies of scale against a backdrop of budget pressures, there may be increasing appetite for employers to seek shared service and resourcing models, as well as give consideration to outsourcing. Where these changes to employer organisational structures cross local authority boundaries, this could lead to further challenges in the legacy approach of membership of their local authority fund. This has already been evidenced by employers who have amalgamated from localised to national organisations in Scotland. e.g. Scottish Police Authority/Police

Scotland; Visit Scotland and Scottish Water. These multi-fund employers find themselves with staff across the country in a variety of different LGPS funds.

Employees

- Confusion with regard to freedom and choice in the pensions arena potentially driving the wrong behaviours and decisions.
- Uncertainty about the impact of the state retirement age and impact on SLGPS.
- End of contracting out.
- Auto enrolment.
- Taxation concerns with regard to annual and lifetime allowances driving 50:50 decisions or contemplation of departure from the SLGPS.
- Mixed messages with regard to ongoing affordability of DB pension schemes in general.

Staffing

- Due to the complexity of pension fund issues, specialist staff are needed. Recruitment of such specialist staff can be difficult due to council terms and conditions, particularly for investment staff and there can be problems in attracting staff to more rural areas. Changes to the investment arrangements for the LGPS in England and Wales could increase competition for investment and legal staff.
- Staff in smaller Administering Authorities often have responsibility for other council duties as well as those related to their pension fund. Resources for the pension fund can be impacted by broader council developments.

Technology

- Demands from members and advances in information technology are increasingly facilitating on-line self-services. System restrictions can be a hindrance to this development.

The implications for these challenges for Administering Authorities are as follows:

Governance

- Strengthening governance, risk management and transparency in response to increased scrutiny.
- Ensuring clarity of roles between Committee and Pension Board.
- Ongoing focus on knowledge and understanding for both Committee members and Pension Boards.
- Advising and supporting the Scheme Advisory Board.
- Balancing the perception that funds' investments are seen as public money and the requirement to manage them in line with fiduciary responsibilities to members and employers.
- Managing key-man risks. The majority of funds out-source investment management and advice to reduce risk.
- Managing risks of additional demands and initiatives.

Investment

- Assessing and monitoring increasingly complex investment options, with the number of managers and portfolios increasing significantly over recent years.
- Ensuring transparency of all costs and managing accordingly.
- Focus on being an active shareholder to enhance long-term value and ensuring transparency of such activities.

Funding

- Reducing cashflow is an increasingly important consideration in setting investment strategy.
- Increased resourcing for managing employers including covenant analysis and managing exits from Funds.

- Potential need for funding and investment options for certain employers different to that of councils and other long-term employers.
- Assessment of options available to multi-fund employers to rationalise the employer contribution rate and membership across funds. This has particular implications where the geographical membership pattern does not match that of the legacy arrangements, leaving the employer at risk of potential cessation or higher costs in one fund with lower membership, compared with increasing membership in one of the other funds or where smoothing could be achieved across funds.

Pension Administration

- Increasing focus on quality of membership data, and the timely receipt of high quality data from employers. Some Administering Authorities are using technology developments to facilitate transfer of data from employers.
- Reconciling Guaranteed Minimum Pensions with HMRC records as a result of the end of contracting out of the State Pension Scheme.
- Communicating complex benefits to members using an increasing range of communication methods.

Multi fund employers find themselves having to provide different formats of data returns and deal with different administration systems, processes and forms across each of the LGPS funds, which increases the in house administration cost and reduces efficiency of the service provided to pension funds as well as introducing a risk of inequity in the provision of pensions information for their staff.

Funding Issues

Background

- Funding is the approach used to pay for pension fund liabilities. They are paid for by a combination of returns from investment, employer contributions and member contributions.
- The important issue for funding is that the approach adopted does not change the cost of the liabilities; it merely affects the pace at which they are paid for.
- Each Scottish LGPS Fund has a number of employers. Administration systems ensure that liabilities are clearly allocated to employers.
- Fund investments are generally managed in one 'pot' i.e. they are not held separately for each employer. However, the majority of funds notionally allocate the investments between employers, albeit with approximations involved in the process.
- Within each Fund, employers are generally invested in the same investment strategy, which for the majority is heavily invested in growth assets. Lothian Pension Fund adopts a different investment strategy for certain employers closer to exiting the Fund.
- Most funds adopt an approach to funding which ensures that each employer pays for its own liabilities.
- When an employer has no active members, a cessation valuation is triggered effectively crystallising the funding position of that employer. This valuation is typically undertaken on a prudent (gilts) basis in order to reduce the risk of other employers having to pay for those liabilities in the future.
- If an employer is unable to pay for its liabilities, and there is no other body in place to pay, the liabilities are shared across the other employers in that Fund.
- Actuarial valuations are undertaken by each administering authority. Under new legislation, Scottish Ministers are required to undertake a comparison of the actuarial valuations of the Scottish LGPS (a 'section 13' report) starting at the 2017 valuation. Results of the dry-run analysis based on the 2014 valuation are awaited.

Funding Challenges

- Reducing cashflow is an increasingly important consideration in setting investment strategy.
- There a need for increased resourcing to manage employers including covenant analysis and managing exits from Funds.
- Potential increasing need for funding and investment options for certain employers different to that of councils and other long-term employers.
- Some employers participate in more than one Fund and there are challenges in relation to different funding assumptions and different contribution rates. The employer needs to decide the Fund in which to place new members. There is a risk of crystallising liabilities (a ‘cessation’) in one Fund whilst continuing to have members in another Fund. This has particular implications where the geographical membership pattern does not match that of the legacy arrangements, potentially leaving the employer with higher costs in a fund with lower membership, compared with increasing membership in one of the other funds.
- The main issues highlighted in the GAD Section 13 Dry Run Report (February 2017) were:
  1. Inconsistent financial assumptions over and above acceptable regional variations;
  2. No standardised approach to disclosure thus clouding comparisons;
  3. Frustration that there is a lack of understanding with regard to the potential variability of contributions by administering authorities and employers;
  4. Confusion re. deficit recovery periods; and
  5. Potentially a need to consider a more formal consistent approach to stress testing.

Funding Considerations for the Different Structure Options

Status Quo of the 11 Funds

- Different funding approaches are taken by the different funds which makes it difficult to see the funding position of the Scottish LGPS as a whole. (It would have been helpful to see the Scottish Government's dry run Section 13 report).
- There should be an assessment of options which should be available to those employers who are admitted to more than one fund to explore options to rationalise funding without triggering cessations.
- There should be clarity on the option of the sub-funds (e.g. the transport funds) to be merged into the main funds. Efficiency gains might be achieved if they could be merged.

Retain the eleven funds but with closer collaboration (examples identified) or share administrative services.

- Shared administration services (with clarity on what this actually means) could bring potential for greater consistencies of funding approach.
- Resource sharing could bring greater consistency of analysing employer covenant and offering different funding options including different investment strategies.
- The immediate implication for individual employer contributions will depend on the difference between the approach adopted by the new administration service and that of the previous administering authority. However, note that the funding approach does not change the liabilities it merely affects the pace at which they are paid for.

One or more common investment pools.

- In this option, it is assumed that actuarial valuations would continue to be undertaken by the individual Funds. Hence pooling of investments is unlikely to affect the approach to funding.
- However investment pooling may provide greater options for different investment strategies. This might allow individual Funds to adopt/offer different strategies for employers in their Funds.

Merge the funds into one or more new funds.

- As assets and liabilities would continue to be earmarked by employer, employers would continue to pay for their own liabilities i.e. merger does not mean cross-subsidising other employers.
- There would be a consistent funding approach within each new fund including approach to employer covenant and potential to offer different funding options including different investment strategies.
- The immediate implication for individual employer contributions will depend on the difference between the approach adopted by the merged fund and that of the previous administering authority. However, note that the funding approach does not change the liabilities it merely affects the pace at which they are paid for.
- This option could solve the issues currently faced by employers who are admitted to more than one fund (see above).
- There may be an opportunity to separate the liabilities of certain employers from others and put in place different funding arrangements, potentially reducing the exposure of the other employers in the Funds. For example, certain groups of employers could be grouped for funding purposes and bespoke admission agreements/guarantees put in place e.g. third sector/charities or colleges.