SCOTTISH ENVIRONMENT PROTECTION AGENCY

**CONSULTATION RESPONSE FORM**

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| **Instructions** Responses in this form should be drafted in conjunction with the accompanying consultation report. To respond, please complete the **respondent details** and as many of the **consultation questions** your organisation wishes to complete and return the form via email to the Pensions Institute at [consultation@pensions-intitute.org](mailto:consultation@pensions-intitute.org) no later than **Friday, 7 December 2018**.  This consultation is being conducted in electronic form only, so **responses must be emailed**; hard copy posted or delivered responses cannot be received. Any queries about the consultation should be addressed to Matthew Roy, Fellow, Pensions Institute at matthew.roy@pensions-institute.org. |

**RESPONDENT DETAILS**

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| **Name of responding organisation(s)** Please list the full name of each organisation participating in this response. | **Organisation type** Is your organisation an administering authority, employer, or employee group? Please record for each responding organisation. |
| SEPA,  Strathallan House  Castle Business Park  Stirling  FK9 4TZ | Scheduled Employer |
| **Authors** Please list any people that wish to be recorded as authors of this response, including name, job title and organisation. | **Consent** Please confirm each author consents to their information being retained for analysing the consultation responses by writing ‘confirm’ by their name. |
| J Welsh, Head of Finance, SEPA  Employer Board Member Falkirk Pension Fund | Confirm |
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| **Date** Please date the response. | 3 December 2018 |

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| **Covering information** If you wish to include covering information with your response, please include the text here. The text can wrap onto additional pages if needed. |
| SEPA is a scheduled body member of the Falkirk Council LGPS.  At 31 March 2017 SEPA had the following membership:  Actives 1230, average age 49.1 years  Deferred pensioners 743, average age 47.9  Pensioners 346, average age 65.2.  SEPA’ asset share of FPF shows it is 90% funded at 31/3/17, with a deficit of an estimated £30m.  The agreed employer’s contribution rate for 2018/19 to 2020/21 is 20%.  19.6% primary rate and 0.4% secondary rate. |

The consultation questions follow.

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| **CONSULTATION QUESTIONS**  **Question 1: Retain the current structure with 11 funds**  The text can wrap onto additional pages. |
| 1. Cost of investing:   How well informed do you feel about the investment costs in your fund? What information do you rely on to specify and measure these?  We could be better informed and we are taking action to be so.  Investment costs cover a range of elements including management fees, transaction  costs, foreign exchange and performance fees. Getting the full details of costs is  complex and requires staff to have the relevant knowledge and skills to obtain it.  To date Falkirk Pension Fund’s (FPF) equity managers have been encouraged to sign up to an agreed Code of Transparency and this has enabled equity costs to be analysed in line with guidance.  We are aware of initiative been undertaken in England and Wales to provide a similar approach to other asset classes, including private equity and infrastructure, this should improve cost transparency.  Some cost information is disclosed in the Falkirk Fund's accounts.  FPF is currently undertaking a cost benchmarking exercise, including an analysis of foreign exchange costs with Lothian Pension Fund using the specialist expertise of Lothian’s in house team. FPF is working towards having the performance objectives of its mandates measured on a net cost basis to allow more meaningful like for like comparison. At present, some mandates are measured gross of fees whilst others are measured net of fees.  • How well does the current system manage investment costs?  The current system allows robust management of these costs.  Practice in this area is evolving. Pension administrators need to build fee transparency requirements into their investment manager appointment process, actively manage contracts and provide regular management information to their committees and boards. The current system allows for all of these activities.  Costs should not be considered in isolation they are a component of the investment decision. Funds should be considering costs alongside the expected gross return of the investment and its risk profile.  How would you improve the measurement and management of investment costs in the current system?  A recommendation of the 2017 Financial Conduct Authority report was that asset managers should provide a consistent and standardised disclosure of costs and charges to institutional investors.  This has been taken forward by the Institutional Disclosure Working Group which has  made the following recommendations, including:  • the use of templates for the collection and analysis of manager data,  • institutional investors to press managers to comply, with non-compliance resulting  in de-selection from appointment short lists and the non-renewal of contracts,  • adoption of the standards by investment consultants,  • greater investment cost education of institutional investors,  • proposals to be encouraged by investment industry rep organisations,  • progress to be reviewed within one year of launch.  FPF is supportive of these recommendations. By adopting the above recommendations the LGPS community will generally be ahead of non-public sector pension arrangements.  The current system allows Fund Managers to get sight of all elements of fees / transaction costs through the procurement and appointment process: this information should be included in the specification of services required and it should be monitored through normal contract management channels and through the Committee and Board scrutiny of investment performance.  There could be improvement in practice of how the funds manage investment managers and report contract service performance to Committees and Boards.  It is important to recognise that certain asset classes that usually provide greater reward are more expensive to access than others (e.g. property, private equity), what is important is overall net return from the investment rather than actual cost of carrying out the investment.  Funds should not lose sight of internal management costs, a format and approach to what is considered internal management costs should be developed in a similar fashion as the template for external mangers costs.  As public sector bodies’ funds have a duty to deliver best value, I would expect them to be undertaking cost comparison to ensure their own costs are reasonable.   1. Governance:   How well informed do you feel about the governance of your fund? What information do you rely on to measure this?  We feel well informed about the governance of FPF.  Information on governance is contained on the FPF website and in the Fund's  Annual Report, its funding strategy, other assorted publications and Joint Committee Board meetings papers.  Governance is an important feature of FPF Committee and FPF Board members training and is regularly covered at the FPF annual conference. Governance matters are regularly covered in reports to the FPF Committee and FPF Board meetings. FPF joint Committee and Board meet on a quarterly basis and are provided with a full suite of reports to enable them to discharge their respective roles. FPF Committee and FPF Board members have access to FPF officers. Assurance that governance matters are being managed to an acceptable standard can be taken from the framework of advisers and auditors of FPF.  FPF Board and FPF Committee members are encouraged to complete The Pension Regulators on line training, which makes them aware of what good governance practice is.  As part of FPF Annual Report and Accounts preparation the fund assesses itself against CIPFA code, which provides FPF Committee and FPF Board with some assurance on the standard of the funds governance.  The FPF has both internal and external auditors who provide assurance on governance matters.  SEPA as a scheduled employer received information from FPF through its membership of the FPF Board. Additionally there is periodic contact with FPF pension’s manager and other staff on day to day operational matters and there is contact with employers on a regular basis though out the formal valuation process on assumptions to be used by the actuaries and management of affordable employer contribution rates looking to the future.  How well is the current system governed?  The current system of governance with its Committee and Board structure is robust.  Governance practice requires FPF Committee and FPF Board members to have appropriate skills and competencies to undertake their roles. On-going professional development is required to keep abreast of changes in pension’s administration and the investment environment.  The same approach will be needed in any future governance structure.  How would you improve governance of the current system?  On-going professional development of Board and Committee members to keep them abreast of changes in pension’s administration and the investment environment.  Improved communications and networking across pension fund Committees and Boards members.  It would improve membership of the Committee if there were more members who are not councillors, for example additional pensioner’s representative and or deferred pensioner’s representative and less councillors. This would provide continuity and allow the development of a depth of knowledge across all pensions’ matters.  How important is it to maintain a local connection with respect to oversight and strategy?  The local arrangements enables employers and Trade Unions to be directly involved in the governance arrangements of their pension scheme.  Local arrangements ensure that local fund’s investment strategy is developed to meet the needs of its members. Demographic profiles vary considerably across Scotland and local arrangements allow for this.  If there is a compelling case made in terms of material cost reduction and increases in investment returns that materially reduces members and employers contributions to the costs of LGPS, by merging funds then local connection should be broken.  The local connection provides scheme members with reassurance that their needs are being considered.  Members have easy access to funds administration and access to information about how their funds are being managed.  The local connection makes it easy for member to seek individual advice on their personal circumstances and facilitates face to face meeting when they need them.  Local arrangements deliver jobs for all areas across Scotland supporting local economies throughout Scotland.  How would you determine if the benefits of a local connection in governance outweigh the benefits of scale?  Pension fund strategy should look at the long term, it has a duty to deliver members benefits. There are two aspects of this 1) Fund’s investment strategy and its implementation of it and 2) administration of the benefits when they are due to be paid.  There are benefits in having a local connection as stated above.  There needs to be a full option appraisal to assess whether small and medium sized Funds can continue to meet their statutory and regulatory obligations in an increasingly complicated and challenging environment.  This assessment would need to take into account:  • key person risk and systems resilience,  • ability to recruit qualified staff across a range of disciplines,  • ability to meet member needs,  • cost per member,   * quality of member’s services.   Socio economic impact of concentrating services is in one area or infrastructure investment required to support dispersed teams needs to be considered.  Some evidence suggests there are economies of scale that outweigh local benefit.  To date the scale benefits of the pooling exercise being undertaken in England and Wales have yet to be delivered.  It should be noted that sometimes there are points in scale where costs start increasing again. Scale does not always reduce administration costs.    There is no evidence to suggest that the current model is fundamentally flawed.  FPF has already recognised the advantages of benefits of scale by seeking to  Collaborate with Lothian Pension Fund around investment matters and have arrangements in place with Lothian to mitigate key person’s risk.  Operating risks:  How well informed do feel about the operating risks of your fund? What information do you rely on to specify and measure these?  We feel well informed about operating risks of FPF. FPF has a risk register which is reviewed by the FPF Committee and FPF Board. Changes in risks and mitigations are brought to the attention of the FPF Committee and FPF Board each quarter. FPF risk register is also reviewed through their internal and external audit process.  How well are operating risks managed in the current system?  FPF has a robust system of internal controls, including oversight from Joint Committee and Board, internal and external auditors, actuaries and independent specialist advisers.  FPF also has a range of internal resources consisting of officers with skills and knowledge in scheme administration, payroll, funding, governance, investments, accounting and communications.  FPF uses a Pensions Administration and Payroll System from a leading software house experienced in LGPS activity.  External investment managers are subject to their own audit arrangements and are  required to produce annual assurance and compliance statements.  How would you improve the measurement and management of operating risks in the current system?  By simplifying the benefits structure. Some aspects of scheme administration are extraordinarily complicated (e.g. 30 contribution rates now compared to 2 rates a decade ago; Certificates of Protection, Aggregation rules to name but a few).  Infrastructure:  How well informed do you feel about your fund’s investments in infrastructure? What information do you rely on?  FPF has been investing in infrastructure as a distinct asset class for approximately 7 years. Initially this was through a global Fund of Fund manager and since 2014, this has been in conjunction with Lothian Pension Fund, leveraging on their in house investment team to execute deals with specialist managers mainly in the UK and (to a lesser extent) in European markets.  Under FPF governance model, FPF Committee determines the strategic asset allocation to infrastructure and delegates the strategic implementation to officers.  Returns are reported to the FPF Committee quarterly with a more detailed analysis of the infrastructure portfolio including risk and return being undertaken by a Joint  Investment Strategy Panel consisting of FPF officers, Financial Conduct Authority accredited officers of the Lothian Fund and Specialist Independent Investment Advisers.  A list of the Fund’s infrastructure investments is posted on the Fund website  How do you rate the current system’s ability to invest in infrastructure?  We rate the current systems ability to invest in infrastructure as adequate.  The fund should only be investing in infrastructure if it is identified as a suitable investment in their Investment Strategy and the fund identifies investment opportunities that meet its investment criteria and generate an acceptable rate of return for the level of risk and illiquidity.  Under the current system, smaller funds and some of the medium sized funds will be investing in Infrastructure assets through a Fund of Funds structure which (FPF has done) allows LGPS Funds to invest in a diversified portfolio of global assets without the administrative overhead that comes from taking a more direct investment route.  The Fund of Funds approach means that there is significant return leakage from fees.  Larger Funds may be able to allocate to a segregated mandate. Larger Funds have the scale to gain access to infrastructure assets using an in house team the more direct approach involves:  • having the capacity to source, analyse and execute deals internally,  • having the capacity to address the legal and tax complexities that will arise, and  • having sufficient market presence and credibility to be offered investment, and   * opportunities at an attractive price.   FPF has only been able to invest directly through its collaborative arrangement with the Lothian Fund. This has enabled FPF to make around 20 investments directly with specialist managers totalling around £100m. The investments include a number of Scottish/UK assets including utilities distribution networks, solar, hydro and wind farms, transportation concessions and water companies.  • How would you increase investment in infrastructure in the current system?  An increase in a Fund’s Investment in infrastructure should only be driven by the fund’s investment strategy designed to meet its members benefit profile.  If and only if a fund’s Investment strategy allocates more to this investment category, should investments of this nature be considered. Then, a decision to invest or not depends on the availability of suitable propositions in the market place that meet the funds expected returns. Infrastructure investments are likely to be attractive to LGPS where the underlying asset has an income stream that is linked to inflation and or underpinned by regulatory requirements such as water or electricity.  Investments need to show the right sort of risk, return and governance characteristics to be potential investments. Infrastructure investments are a complex vehicle, are illiquid and carry risks (as evidenced by the demise of Carillion and the collapse of the Morandi Bridge in Genoa).  Do you have any additional comments about this option?  The current structure is well known and has generally delivered for the LGPS  Scotland. The Scottish funds are all close to or above 100% funded, meaning that their primary objective has been achieved. The LGPS in Scotland has for very many years been better funded than its equivalent in England.  The current structure probably suits the larger Scottish Funds better than smaller funds in terms of them being able to obtain lower investment fees and achieve economies of scale generally. Smaller funds also have the challenge of how to build in resilience in terms of succession planning and risk management.  As a whole, the Scheme faces significant challenges in the form of:   * complicated legislation, * employer affordability, * the demand for improved governance standards from the Pensions Regulator, * cyber security and * environment and sustainability risk management, as we transition to a low carbon world to meet climate change challenges.   All of these challenges will persist irrespective of the structure in place. |

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| **Question 2: Promote cooperation in investing and administration between the 11 funds**  The text can wrap onto additional pages. |
| 1. Cost of investing:   *What impact do you think promoting agreements between funds would have on investment costs?*  There should be some savings through joint procurement of investment managers  and peripheral services (e.g. proxy voting, ESG advisors, etc.). Work in this direction has already been done in Scotland through the use of National Frameworks for services such as actuarial, investment consultancy and custody services.  Further savings may be achieved if Funds are able to tap into an internal investment  resource, although stringent regulatory standards and the need to remunerate such  staff appropriately are potential barriers.  *What would be the positive impacts?*  Savings on investment costs; ability to access a wider range of asset classes;  improved implementation of strategy; improved investment manager management, better performance analysis and improved understanding of risk.  *What would be the negative impacts?*  For collaboration work to be successful there needs to be mutual benefits for all the Funds in the relationship (e.g. a financial contribution from the smaller funds to enable the shared resource costs to be shared).  Funds have to invest resources to work together at a variety of different levels.  It is unlikely larger funds would benefit.   1. Governance:   *What impact do you think promoting agreements between funds would have on governance?*  This largely depends on the extent of the collaboration between funds. FPF  experience of collaboration with Lothian on infrastructure investing is that for this to  work effectively there needs to be similarity in the governance arrangements of the  two Funds (i.e. delegation to officers to enable swift decision-making to take place).  Collaboration requires resources at a variety of levels across the teams to work well together.  *What would be the positive impacts?*  There would be opportunities for funds to share resources: reduce costs and learn from each other, developing and implementing best practice.  *What would be the negative impacts?*  Arrangements involving multiple funds will be more complicated than the status quo. As stated above there needs to be benefits for all funds in the collaboration. The larger funds may not benefit. Collaboration requires resources in the form of staff to be available to work together, increasing administration costs.   1. Operating risks:   *What impact do you think promoting agreements between funds would have on operating risks?*  A positive one. For medium sized and smaller funds, collaborating with other larger  Funds will assist with risk management, including key man risk and general resilience.  *What would be the positive impacts?*  See above. Collaborations can evolve as they suit funds, to the needs of the Funds concerned and where best value for the fund can be demonstrated.  *What would be the negative impacts?*  The reduction in key person risk is limited in that a smaller fund can only expect a  larger fund to be provide back up where key person risk crystallises.  High level of specialist skills and knowledge would need to be retained across the 11  Funds so there is still duplication of effort and systems.   1. Infrastructure:   *What impact do you think promoting agreements between funds would have on funds’ ability to invest in infrastructure?*  A positive one. Agreements may allow smaller funds to gain access to infrastructure  in a cheaper manner than the traditional Fund of Fund route. They could share the costs of due diligence etc.  *What would be the positive impacts?*  Same as above. Promotes greater understanding of the asset class; brings scale to  prospective investments; opportunity for reduced fees; better alignment between the  actual investment and Fund objectives; reputational dividend if Funds are seen to  invest in UK economy  *What would be the negative impacts?*  No negative impacts other than local resource requirement should not to be underestimated for smaller funds.   1. Do you have any additional comments about this option?   Significant co-operation between the Scottish funds and the wider LGPS network already exists. LGPS (UK) National Frameworks are in place and are widely used for a range of services including actuarial, investment consultancy, stewardship, global custody, performance and cost monitoring, legal, transition management and third party administration services.  Scottish LGPS framework agreements have been put in place for portfolio management, member tracing, and scheme administration. Much good joint work was undertaken in 2014 and 2015 to promote the new Career Average Version of the Scheme including agreeing web content and using multi media. There is scope and willingness to foster further collaborations as opportunities arise.  FPF experience of entering into a collaborative agreement with Lothian has been  extremely positive enabling the Fund to make £100m worth of investments into around  20 different vehicles. |

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| **Question 3: Pool investments between the 11 funds**  The text can wrap onto additional pages. |
| 1. Cost of investing:   *What impact do you think pooling investments between funds would have on the cost of investing?*   |  | | --- | | The larger funds will already enjoy benefits of scale. It is unlikely that this would improve significantly through adding further scale. |   The extent of cost savings in the smaller to medium sized funds will depend on their existing costs. They could collaborate and reduce costs.  *What would be the positive impacts?*  The academic research indicates that there should be savings in fees and access to a wider range of investments. What is not clear is if these savings could be delivered if there was better collaboration, use of national contracts and or improved contract management.  *What would be the negative impacts?*   |  | | --- | | Reducing cost is only a positive impact if it improves net returns. Cost reduction through pooling would be a negative if it led to a restricted choice of investment options, and reduced returns or increased risk.  Some very attractive investment opportunities, particularly in private markets, have limited availability. A larger pool may be unable to achieve its desired allocation and is unlikely to achieve cost savings as managers have no need to offer cost incentives where demand outstrips supply. |  * *If asset pooling were possible, under what circumstances should a fund consider joining an asset pool?*   A fund should carry out its own cost benefit analysis of the merits of joining an asset pool. Until a pool is established this is difficult as neither the costs nor the benefits are clear or certain  *Under which circumstances should the SLGPS consider directing funds to pool?*  Manifest failure by a fund, or the Scottish LGPS funds collectively, to achieve their objectives might present a basis for directing funds to pool.   1. Governance:   *What impact do you think pooling investments between funds would have on governance?*  Where pools oversee external investment managers, this represents an additional layer of governance between the fund and the manager. It is likely to reduce transparency and complicate governance.  Where pools manage investments internally, the funds may become captive – i.e. it would be difficult to replace the internal management team if they underperformed.  *What would be the positive impacts?*  There may be a saving in fees and transaction charges.  *What would be the negative impacts?*  Diverting resource to establish and maintain the pools is likely to be a significant distraction from the ongoing business of managing the funds. It adds a level of cost which will reduce net returns to the funds.   1. Operating risks:   *What impact do you think pooling investments between funds would have on operating risks?*  Where pools oversee external investment managers, pooling is unlikely to have any impact on operating risks, as day-to day investing is carried out by the managers.  Where pools manage investments internally, they would need to develop risk-management capabilities on a par with external managers who typically have extensive compliance and risk-management resources.  *What would be the positive impacts?*  The investment risks associated with a type of investment would not be reduced by pooling. The benefits administration risks would not be reduced by pooling assets  *What would be the negative impacts?*  Diverting resource to establish and maintain the pools is likely to increase operational risks. There will be additional costs of the administration of the pool.  Pooling investments is likely to involve some concentration of risk.   1. Infrastructure:   *What impact do you think pooling investments between funds would have on funds’ ability to invest in infrastructure?*  Very little, if any. Investments in infrastructure will be driven by the fund’s investment strategy and finding suitable opportunities for investment that meet the fund’s investment criteria.  FPF benefits from Lothian’s established infrastructure program. Large and medium sized funds are already able to invest in infrastructure.  It is not clear why the smaller funds are not investing in infrastructure. Pooling investments might facilitate it if their Investment strategy dictates the need for infrastructure investments.  *What would be the positive impacts?*  Infrastructure investment typically does operate on a pooled basis – with investors pooling resources, usually through a limited partnership structure to increase their buying power and share risk.  A combined initiative by the Scottish funds to invest in infrastructure could have some merit. Creation of a pooled investment vehicle in which funds could invest would achieve this if the vehicle was sufficiently attractive on a risk/return assessment  *What would be the negative impacts?*  The consultation paper acknowledges that: “In the short-term, pooling would generate large initial transitional and set up costs, potentially including the requirement to seek FCA authorisation for the new asset pools.”  Decisions regarding the structure and operation of the funds should be made to deliver improved outcomes for members.   1. Do you have any additional comments about this option?   This option is topical given the wholesale, directed and enforced pooling exercise currently underway in England & Wales.  It is much too early to judge the success of that exercise but it is apparent that it is costly and time-consuming; that very different approaches are being adopted by the different pools; and that it is creating resource gaps as staff transfer away from administering authorities.  The payback period for costs incurred is likely to span many years and it is also likely to be some time until the pools settle fully into their new structures. |

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| **Question 4: Merge the funds into one or more new funds**  The text can wrap onto additional pages. |
| 1. Cost of investing:   *What impact do you think mergers between funds would have on the cost of investing?*  A positive impact. The Falkirk Fund has assets of £2.3bn. A reduction in fees of 5bps (5 basis points = 0.05%) translates into a saving of around £1.2m per annum. Savings would not be realisable from every asset classes (some costs are unavoidable being tied into longer term illiquid assets). Where savings are achievable, this would take time to gain traction and most likely occur as mandates were re-let. The bottom line is that a merged Fund could expect to have increased buying power to secure lower fees.  The costs of the larger funds are unlikely to be reduced.  *What would be the positive impacts?*  A merged structure would bring greater clarity and certainty to decision making (compared with collaboration) as there would be one agreed Fund strategy and one set of investment principles to be adhered to. With collaboration, differences could still exist around investment objectives, ESG beliefs making governance more cumbersome.  Any fee savings would help with fund solvency and feed into a stronger funding base or lower employer rates. (Although, in this regard, a ‘normalisation’ of interest rates is far more likely to have a marked impact on solvency).  Better investment governance through the larger entity being able to afford and attract more specialist expertise. More engaged in ESG matters / better stewardship of Fund in terms of its role as a responsible investor.  *What would be the negative impacts?*  There are likely to be transitioning costs in re-aligning investment strategies albeit strategies could be harmonised over time as mandates came up for renewal.  There will be an impact on fund staff. If administration of benefits are streamlined, there will be a reduction in staff employed.  The increased responsibility on internal monitoring of investment management is likely to drive the need for more skilled staff, which in turn will increase costs as they are likely to be higher paid than the existing staff.  *If merging were possible, under what circumstances should a fund consider a merger?*  Clearly, this would need to be given mutual consideration by at least 2 funds. Each would need to carry out its own cost benefit analysis that demonstrates that such a change delivers better outcomes for its fund members than the existing structure.  *Under what circumstances should the SLGPS consider directing funds to merge?*  Directing funds to merge would be appropriate if merger is the structure that delivers the best outcome for local government stakeholders (i.e. scheme members and pensioners and employers).   1. Governance:   *What impact do you think mergers between funds would have on governance?*  A major impact. Merger would inevitably reduce or remove local involvement in pension fund governance. The degree of this would depend on the model and extent of the merger  Which Council or Joint Body would be designated the Administering Authority of the merged Funds? To what degree would the old funds have representation in the new Fund? For example, if Falkirk, Fife and Lothian merged, with Lothian as the Administering Body, would Falkirk, Stirling, or Fife Councils be represented on the Pensions Committee? If so, how would West, East and Midlothian Councils be represented?  *What would be the positive impacts?*  Fewer Pension Committees and fewer Boards so more streamlined arrangements and reduced duplication of effort. Arguably better chance for Committees and Boards to be ‘staffed’ by members with appropriate skill set. This is only truly a positive if the merged model is more effective. It is not clear how this can be or will be objectively assessed.  *What would be the negative impacts?*  A merged model would increase the reliance on a smaller number of individuals and professional advisors. If things go wrong, they could go wrong with a far bigger impact across Scotland.  Arrangements would need to be made to engage with employers and Trade Unions across Scotland.  Member services may suffer.  There will be an impact on staff morale across Scotland   1. Operating risks:   *What impact do you think mergers between funds would have on operating risks?*  It should reduce some operating risks. With larger entity, there would be the opportunity to build a best in class resource covering the wide variety of specialisms demanded by the statutory and regulatory environment e.g. investment, administration, risk management, accounting, funding, legal, governance, communications, tax, data security, data quality, compliance. Many of these areas have their own underlying specialisms making it a challenge for small and medium sized funds to cover all the bases  Investor’s diversification is the primary risk mitigation for funds. Merging investments is certain to involve a concentration of risk.  Size is not a guarantee better outcomes  *What would be the positive impacts?*  Arguably better outcomes for members and employers – Reduced risk of non-compliance. Potential for better risk control e.g. key man risk.  *What would be the negative impacts?*  Scheme members could feel more remote from decision making, but do they care that much?  Members could be suspicious around motives for fund mergers – wary of it being 1st step in a ‘cash and grab’.  There could be a greater concentration of investment risk.   1. Infrastructure:   *What impact do you think mergers between funds would have on funds’ ability to invest in infrastructure?*  The merged fund will need to set an appropriate strategic allocation for its investment portfolio that will deliver sufficient income to pay its members benefits as they fall due. The strategic allocation for infrastructure may be higher or lower as a result of this exercise. If it is higher and they can identify appropriate infrastructure investments that meet their investment criteria they will then invest.  A merger could enable the enlarged funds to access larger scale infrastructure projects, although such large scale projects may not necessarily be appropriate for the Funds to invest in (risk, return and price would all be relevant).  Merging funds to achieve more investment in infrastructure (which is not a fund objective), is not a sufficient basis to merge funds.  *What would be the positive impacts?*  Potentially more investment in large scale projects  *What would be the negative impacts?*  Potentially less diversity / more concentration of risk through investing in larger projects.   1. Do you have any additional comments about this option?   Arguably, merger delivers the most secure arrangement for scheme members (in terms of creating resilience and minimising key person risk) and potentially the most cost effective structure for employers.  However, it does bring major governance challenges such as who runs the Fund(s); who is represented on it; how many Funds should there be; how the link between local democracy and Fund(s) is maintained?  Evidence is also mixed that the largest funds will be the most successful in terms of funding, although this does seem to be the case in LGPS Scotland universe.  A merger should only be pursued into one or more Funds across Scotland if there is a robust business case that demonstrates the benefit to all members and employers of the Scottish schemes.  If merger is pursued, there would be a significant body of work to be undertaken by SPPA as well as the Funds. The effort and potential disruption should not be underestimated. Do funds have the capacity to cope with managing the change?  What impact will this have on fund valuation and employer contributions in short, medium and long term? |

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| **Question 5: Preferred and additional options**  The text can wrap onto additional pages. |
| Which option does your organisation prefer? Please explain your preference.  In terms of on-going investment cost savings and the management of scarce staff resources SEPA is of the opinion that it would make sense to create 2 or 3 independent Pension Management Bodies for Scotland. The reasons for suggesting 2 or 3 are:   * Strathclyde is sufficiently large to reap benefits of scale, merging into one fund is unlikely to benefit them. * One fund would be susceptible to government pressure, particularly in times of economic stress.   That said the case needs to be prepared to demonstrate that the benefits to members and employers in terms of costs saved and reduction in resourcing and other risks are greater than costs and risk of undergoing such a major change.  These single purpose Pensions Bodies should be responsible for the day to day operation of the scheme. Such single purpose bodies should lead to improved staff skills and competencies and encourage development of in-house investment management teams.  How each Body is structured will depend on their geographical coverage and how they think they can get the best value for money. Their structural design should support their needs in the most appropriate manner, this maybe by having a central office with local support. Or it may be consolidating all activities into one office.  Each Body should have a Board that consists of Employer 4 reps (from councils ( councillors or chief Finance Officers ) or other membership bodies), 4 Employee reps, 2 pensioner reps and 2 independent members. The independent members will provide challenge and ensure the Board is managing the fund within existing legislation/ regulation.  To maintain the level of knowledge required to be effective in these roles it is suggested that they become 10 year terms of office.  These Pensions Bodies Boards must have an active local engagement programme with all its participating employers and members, (pensioners, actives or deferred).  The new bodies should be given the responsibility to inform staff of their relevant employers of their pensions benefits and their options in managing their finances for retirement.  What other options should be considered for the future structure of the LGPS?  SEPA’s second preference would be seek more collaboration and joint working across schemes.  FPF has been proactive in undertaking collaboration with Lothian. A number of the benefits indicated by the academic research provided are already being delivered in this arrangement.  The LGPS in Scotland has a good existing network of communication between funds at Pensions manager level, its current focus is largely on information sharing and problem-solving rather than cost saving or delivering service efficiencies. This group remit could be revised and broadened. They could be tasked with the following:   * development of a forward programme to of joint investment (including infrastructure), * a Scottish procurement framework for all advisor support, * undertaking joint or shared due diligence, * joint engagement on environmental, social or governance issues, * shared administration and communications. etc., * a regular, formalised meeting of fund conveners.   Like any other options costs and benefits of undertaking activities should be identified to show that there is net benefit to the scheme members.  What would be the advantages and disadvantages of these other option for funds’ investment costs, governance, operating risks and ability to invest in infrastructure?  Development of the structure on a collaborative basis as suggested above, could generate many of the advantages of the individual options identified without the disruption, transitional costs, risks and likely unintended consequences that will result from merging fund.  Are there any other comments you would like to make?  It should be remembered that LGPS is there to pay members benefits many years ahead.  LGPS forms a key component of local government and other Scottish employer’s remuneration packages. For a number of years public sector has restrained pay rises across the public sector and as an employer LGPS is part of it is the package of benefits that attracts new staff.  As an employer working in the Scottish public sector where core funding has been reduced, managing the increasing costs of pension contributions reduces our ability to deliver front line services for the people of Scotland. |

The consultation questions end.