## Review of the Structure of the Scottish Local Government Pension Scheme

**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 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 organisationparticipating in this response. | **Organisation type**Is your organisation an administering authority, employer, or employee group? Please record for each responding organisation. |
| full names of responding organisations**Glasgow City Council (Strathclyde Pension Fund)** | **Administering Authority** |
| **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. |
| **Richard McIndoe, Director**  | **confirm** |
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| **Date**Please date the response. | Date 06.12.2018 |
| **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. |
| Glasgow City Council is the Administering Authority for the Strathclyde Pension Fund.Key figures for the Strathclyde Pension Fund as at 30th September 2018 are as follows.

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| **Membership** | Employee members 96,000 |
|  | Deferred members 62,000 |
|  | Pensioner members 78,000**Total Membership 236,000** |
| **Employers** | **173** These include the 12 local authorities in the west of Scotland; Police Scotland, Scottish Fire and Rescue, and Scottish Water; a number of universities and colleges; local authority subsidiary companies and contractors; and a wide range of other organisations with funding or service links to the local government sector. |
| **Investment Assets** | **£21.997 billion** invested in a globally diversified strategy spanning equity, debt, property and infrastructure in both public and private markets.This includes a **£1 billion** Direct Investment Portfolio which targets investments with some added value through local, economic or ESG (Environmental, Social, Governance) impact.SPF is a signatory to the UN Principles for Responsible Investment.  |
| **Investment Performance** | 3-years: **14.2% p.a.**5-years: **10.9% p.a.**Since inception (1975): **11.6% p.a.** |
| **Funding** | Estimated funding level (assets/liabilities): **114.5%**.The Main Employer Group pays a contribution rate of **19.3%** (of pensionable payroll). This rate has been stable since **2010** and will continue until at least **2021**.  |

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| **CONSULTATION QUESTIONS**Question 1: Retain the current structure with 11 fundsThe 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?

The investment industry has not been entirely transparent in respect of costs, though there has been some improvement in recent years. In 2014, CIPFA published guidance on *Accounting for Local Government Pension Scheme Management Expenses* in an effort to achieve full disclosure of costs on a comparable basis between pension funds. The guidance was revised and re-issued in 2016.Strathclyde Pension Fund (SPF) has complied fully with the CIPFA guidance since initial publication*.* All investment management costs are recognised, measured and disclosed in the Fund Account in line with the guidance. This includes costs which are sometimes described as “hidden” and are not currently provided as standard by investment managers. Total disclosed expenses for SPF include management fees, management fees in pooled funds, performance fees, and transaction costs.SPF also participates in a number of cost and performance benchmarking exercises. The results are generally not published, but SPF would have no objection to publication.* How well does the current system manage investment costs?

The Financial Conduct Authority’s (FCA) recent final report on its *Asset Management Market Study*, which is referred to in the Scheme Advisory Board (SAB) structural review report, highlights a number of weaknesses in the current asset management system in the UK. These include weak price competition, a lack of transparency, and a lack of alignment of fees and performance. These issues apply particularly to small, retail investors. (There are 33,000 DC pension schemes in the UK with less than 11 members.) The report confirmed that large institutional investors are able to negotiate very effectively and get good value for money. In this context, Local Government Pension Scheme (LGPS) funds are all large investors.LGPS funds also benefit from other public sector disciplines including open competitive tendering, a value for money ethos, and high levels of scrutiny and transparency in comparison to corporate funds. SPF maintains these disciplines, and also benefits from very significant economies of scale given its size of almost £22 billion. * How would you improve the measurement and management of investment costs in the current system?

The FCA report proposes a package of remedies including strengthening the duty on fund managers to act in the best interests of investors, consistent and standardised disclosure of costs and charges to institutional investors, and proposals to improve the effectiveness of intermediaries. SPF would support these measures, albeit they are addressed more towards smaller investors. Considerable progress has already been made with the introduction of the Transparency Code in 2016, MiFID II (the Markets in financial Instruments Directive) in January 2018, a private equity transparency initiative by ILPA (the Institutional Limited Partnership Association), and ongoing work by the FCA’s Institutional Disclosure Working Group.To ensure consistency across LGPS funds, SPF would support mandatory application of the CIPFA guidance on *Accounting for Local Government Pension Scheme Management Expenses.* SPF currently applies this guidance as a matter of best practice1. Governance:
* How well informed do you feel about the governance of your fund? What information do you rely on to measure this?

SPF has a dedicated Governance area on its website, a Governance section in its Annual Report, and Governance is a standing item at the SPF AGM. See:<https://www.spfo.org.uk/index.aspx?articleid=14464><https://www.spfo.org.uk/index.aspx?articleid=14493><https://www.spfo.org.uk/index.aspx?articleid=22913>The SPF governance structure above includes all the mandatory elements introduced by the Public Service Pensions Act 2013 together with elements distinctive to SPF.* How well is the current system governed?

The current system of governance in the Scottish LGPS was only recently introduced - in 2015. It was the result of extensive review by a UK government commission leading to primary legislation and new scheme regulations. In 2016, the Scottish Public Pensions Agency (SPPA) commissioned KPMG to undertake a review of the arrangements. The review’s findings overall were positive and no fundamental weaknesses were identified, though KPMG made a number of recommendations addressed at helping the new Boards establish their purpose. * How would you improve governance of the current system?

Recommendations from the KPMG review should continue to be worked through and implemented. * How important is it to maintain a local connection with respect to oversight and strategy?

The LGPS represents a very significant benefit for scheme members and a significant cost for employers. A local connection is essential to ensure that both employers and members can exercise meaningful oversight, and that strategy is fully aligned to their interests. * How would you determine if the benefits of a local connection in governance outweigh the benefits of scale?

Given that the strong local connection represents the status quo for the LGPS in Scotland it would be necessary instead, in order to advocate fundamental change, to determine that greater benefits of scale would outweigh the benefits of the local connection. Some academic evidence might suggest so, but this cannot be established with any certainty *ex ante*. There is no evidence to suggest that the current model is fundamentally flawed. Indeed, the LGPS in Scotland is a considerable success story.1. 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?

SPF has a published Risk Policy and Strategy Statement which is available at:<https://www.spfo.org.uk/index.aspx?articleid=20464>A summary Risk Register is reviewed each quarter by the SPF Committee and Board.The detailed Risk Register is reviewed and published annually:<http://www.glasgow.gov.uk/councillorsandcommittees/submissiondocuments.asp?submissionid=87156>* How well are operating risks managed in the current system?

SPF has a strong risk management culture. The funding and investment strategies are firmly risk-based and all operational risks are closely managed. The Strathclyde Pension Fund Office (SPFO) has significant internal resource and expertise, and a robust regime of internal controls. The internal resource is supported and enhanced by a framework of external monitoring and advice including actuarial and investment consultants, auditors, and independent expert advisers (the Investment Advisory Panel). External investment managers have significant risk and compliance resources.* How would you improve the measurement and management of operating risks in the current system?

The complexity of the scheme regulations and associated legislation severely exacerbates operating risks. The regulations should be simplified.1. Infrastructure:
* How well informed do you feel about your fund’s investments in infrastructure? What information do you rely on?

SPF has made 18 separate investments totaling over £500m in UK infrastructure, including £150m in Scotland, through its Direct Investment Portfolio (DIP). These span social and transport infrastructure and renewable energy including onshore wind, offshore wind, solar, small scale hydro and community power schemes.SPF has also recently agreed to invest £500m in a global infrastructure fund.Detailed proposals for each of these investments are published in the committee papers area of the Fund’s website:<https://www.spfo.org.uk/index.aspx?articleid=16036>A complete list of DIP investments is published in the quarterly investment performance report and in the investments section of the SPF Annual Report.* How do you rate the current system’s ability to invest in infrastructure?

As with other asset classes, infrastructure investment requires a sound understanding of risk, return and governance characteristics. Like other private markets investments, infrastructure is relatively illiquid, supply-constrained and expensive. But there are no insurmountable barriers, as SPF’s £1 billion of investment to date demonstrates. * How would you increase investment in infrastructure in the current system?

Levels of investment in any asset class are largely determined by its attractiveness relative to other alternatives. For example, the feed-in-tariff regime has been instrumental in increasing institutional investment in renewable energy. SPF has taken full advantage of this opportunity with investments of over £330m. Investment in infrastructure would increase if the supply of attractive opportunities increased, or the risk/return characteristics were improved. 1. *Do you have any additional comments about this option?*

It is worth re-iterating that the LGPS in Scotland is a considerable success story.This can best be evidenced in the funding position. 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 and the rest of the UK.SPF has won multiple industry awards over many years - 5 in 2017- recognising our performance, service delivery, and commitment to innovative, responsible, long-term investing. Other Scottish LGPS funds have also been frequent award-winners.The scheme does face significant challenges in the current, difficult pensions environment. A number of these are described in the SAB structural review report. Funds will need to adapt to address these, but these challenges do not stem from the current structure, and revising the structure is unlikely to be a panacea for them.  |

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| Question 2: Promote cooperation in investing and administration between the 11 fundsThe 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 could be some saving from, for instance, commissioning joint consultancy reports or reviews. Joint procurement of investment managers and other services can also save duplication of the cost of the exercise and lead to reduced fees. * What would be the positive impacts?

Some cost saving, though this is unlikely to be material for SPF. Positive benefits, particularly for smaller funds are more likely to be shared and improved understanding of risk, and more efficient use of internal resources.* What would be the negative impacts?

None.1. Governance:
* What impact do you think promoting agreements between funds would have on governance?

No significant impact on individual governance structures, but may lead to better outcomes. * What would be the positive impacts?

Reduced duplication of governance effort. Improved collective governance of the scheme* What would be the negative impacts?

No significant negative impacts, but the need to co-ordinate activity and decision-making would be a complication.1. Operating risks:
* What impact do you think promoting agreements between funds would have on operating risks?

No significant impact for SPF.* What would be the positive impacts?

Could improve risk management and support for smaller funds.* What would be the negative impacts?

No significant negative impact.1. Infrastructure:
* What impact do you think promoting agreements between funds would have on funds’ ability to invest in infrastructure?

Jointly-commissioned consultancy reports, due diligence and legal review could reduce costs and facilitate some additional investment. * What would be the positive impacts?

Marginal benefit to larger funds. Might remove perceived barriers for smaller funds. * What would be the negative impacts?

No significant negative impact.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.SPF has carried out joint due diligence with other funds on some investments.Introduction of LGPS 2015, and the associated member and employer communications, was a large-scale collaborative exercise between all the Scottish funds. There is undoubtedly scope and willingness to build further on these initiatives. |

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| Question 3: Pool investments between the 11 fundsThe 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?

At £21 billion, SPF already enjoys significant benefits of scale. It is unlikely that this would improve significantly through adding further scale. SPF typically pays the lowest fee tier available to investors or a lower negotiated rate. * What would be the positive impacts?

It is unlikely that SPF would see any significant positive cost impacts from pooling investments.* 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?

It is unlikely that SPF would see any significant positive governance impacts from pooling investments.* 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.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?

It is unlikely that SPF would see any significant positive impacts on operating risk from pooling investments. * What would be the negative impacts?

Diverting resource to establish and maintain the pools is likely to increase operational risks.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.Of the large Scottish Funds: SPF has made investments of over £1 billion to date in infrastructure and will continue to make new investments; Lothian has an established infrastructure programme. Amongst the medium-sized funds: per the Scheme Advisory Board Annual Report for 2016/2017, Fife and Falkirk are shown as having infrastructure investments.So, large and medium sized funds are already able to invest in infrastructure. The smaller funds (<£1 billion) do not appear to have made any infrastructure investments. It may be that they lack the resource to do so, though with consultant support it is not clear why this would be the case. Pooling investments might facilitate infrastructure investment by these funds, but their total assets are £2.3 billion of the £43 billion total scheme assets, so this would not materially change the total investment in infrastructure. * 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. This is the model for all of SPF’s existing infrastructure investments, including the Pensions Infrastructure Platform (PIP), which was created by a group pf UK pension funds, including SPF, to invest in UK infrastructure.A combined initiative by the Scottish funds to invest in infrastructure could have some merit. The recent report by the Scottish Futures Trust (SFT) on *Scottish Real Asset Investments and the Local Government Pension Scheme* identifies an area of investment that “enables LGPS to meet their fiduciary duties with good risk adjusted returns that are not highly competed by other investors: as those investments are not highly competed for by other investors, investment in them will provide a level of additionality to the Scottish real asset stock, and where they relate to new developments, they will provide additional Scottish capital stock.” It should be stressed, though that:* the positive impacts identified by SFT are not related to the objectives of the LGPS and its funds; and
* it would not be necessary to pool funds in their entirety to facilitate investment in infrastructure. The 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.” Pooling the funds simply to achieve more investment in infrastructure, which is not a primary pension fund objective, would be a perverse decision in this context. 1. Do you have any additional comments about this option?

This option is clearly topical given the wholesale, directed and enforced pooling exercise which is 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. SPF would not support this approach in Scotland, but there might be some merit in more selective pooling, on a voluntary basis either of individual asset classes or by specific groups of funds.  |

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| Question 4: Merge the funds into one or more new fundsThe 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?

Answer as for pooling at 3.a, above.* What would be the positive impacts?

Answer as for pooling at 3.a, above.* What would be the negative impacts?

Answer as for pooling at 3.a, above, but the transitional costs would be much greater.* 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 of the merits of merging. A merger should only proceed if it was mutually beneficial. * Under what circumstances should the SLGPS consider directing funds to merge?

Answer as for pooling at 3.a, above.1. Governance:
* What impact do you think mergers between funds would have on governance?

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. * What would be the positive impacts?

A merged model would require less governance resource than individual governance models, but this is only truly a positive if the merged model is more effective.* What would be the negative impacts?

 A merged model would increase the reliance on a smaller number of individuals.1. Operating risks:
* What impact do you think mergers between funds would have on operating risks?

In some instances merger can be beneficial – i.e. if the merged entity was more likely to achieve the objectives than either/any of the separate entities individually. However, for investors diversification is the primary risk mitigation. Merging investments is certain to involve a concentration of risk. A full merger of Scottish funds might have slightly increased probability of success. But size is no guarantee of success, and the impact of failure would be very significant.* What would be the positive impacts?

Potentially, better risk models.* What would be the negative impacts?

Concentration of risk.1. Infrastructure:
* What impact do you think mergers between funds would have on funds’ ability to invest in infrastructure?

A full merger of Scottish funds could increase investment in infrastructure, but this would depend on the investment strategy of the merged fund and those managing it.However, merging the funds simply to achieve more investment in infrastructure, which is not a primary pension fund objective, would be a perverse decision. * What would be the positive impacts?

A merged fund or funds could potentially make larger individual investments.* What would be the negative impacts?

Larger individual investments could represent a greater concentration of risk. 1. Do you have any additional comments about this option?

At the extreme, merger into one fund would be likely to break the direct link between the scheme and local government by taking the fund out of local government control. Whilst a fund of this size would undoubtedly enjoy benefits of scale, size is not a guarantor, nor necessarily a determinant of success. The UK’s 2 largest pension funds are the Universities Superannuation Scheme (USS) and the British Telecom Pension Scheme (BTPS). Both have assets of around £50 billion (a little more than the combined value of the Scottish LGPS funds). Both are very well managed in many respects. Yet both have significant funding deficits – in excess of £10 billion in each case – and are contemplating, or have effected closure of their schemes to new defined benefit accrual.  |

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| Question 5: Preferred and additional optionsThe text can wrap onto additional pages. |
| 1. Which option does your organisation prefer? Please explain your preference.

SPF has a current value of £21.997 billion, current membership of 236,000 and a current funding level in excess of 114%. SPF has a governance structure and risk processes appropriate for a fund of this very significant size, utilising internal and external expertise. SPF enjoys considerable benefits of scale in terms of cost, influence, and access to investments and is able to manage or avoid the potential downside that scale can bring (lack of flexibility, insufficient scale of opportunity, concentration of risk). SPF has existing infrastructure commitments of over £1 billion. The infrastructure strategy is relatively new and this total is likely to increase, particularly if attractive opportunities continue to emerge. From an SPF perspective, it is not clear what would be gained by its members or participating employers from adoption of any of the proposed alternative models. It is certain, though, that there would be significant costs and risks associated with any change. 1. What other options should be considered for the future structure of the LGPS?

Whilst the other Scottish funds may not enjoy the same benefits of scale as SPF, they do appear to be achieving their objectives.The scheme does face significant challenges in the current, difficult pensions environment, and funds will need to adapt to address these. There are extant examples of how the other options considered in this consultation can assist with this.These include:* collaboration between all the funds to introduce the LGPS 2015 scheme
* the joint Lothian and Falkirk initiative on infrastructure investment
* the creation of a pooled investment vehicle for Scottish real assets currently being developed by SFT.

These are all recent developments which have occurred organically within the existing LGPS structure rather than by any form of enforced direction or change of structure. There is undoubtedly more scope for further development of these and similar initiatives within the current structure, and this should be encouraged and actively supported for the benefit of the funds and their members and participating employers. Future development of the structure may also involve pooling or merger of funds but this should only occur where individual funds agree that this would be to the benefit of their members and employers. Smaller funds should give serious consideration to these options.The LGPS in Scotland has a good existing network of communication between funds, but its current focus is largely on information sharing and problem-solving rather than structural development. Some reorganisation of this would be required in order to support co-ordinated development. This might include the following:* development of a forward-looking programme to consider potential initiatives such as:
	+ joint investment, including in infrastructure
	+ joint or framework procurement
	+ joint or shared diligence
	+ joint engagement on environmental, social or governance issues
	+ shared administration and communications.
	+ etc.
* a regular, formalised meeting of fund conveners
* adding resource at a Scheme Advisory Board or cross-fund level, as well as in some instances at fund level
* establishment of more localised “hubs” to consider structural and investment matters – potentially 3: for the North, West and East of Scotland.

SPF would be happy to support, participate in and, where appropriate, lead such initiatives 1. 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 cost and likely unintended consequences that selecting and mandating one option would produce. 1. Are there any other comments you would like to make?

It should always be remembered that pensions provision is a very long-term undertaking. Structural development should be clearly focused on the long-term sustainability of the scheme rather than any more transient imperative or objective.  |

The consultation questions end.