Review of the Structure of the Scottish Local Government Pension Scheme

CONSULTATION RESPONSE FORM

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

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.
Falkirk Council (in its capacity as the Administering Authority of the Falkirk Council 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.
Bryan Smail, Chief Finance Officer	**Confirmed**
Alastair McGirr, Pensions Manager	**Confirmed**

Date	**06/12/2018**

About Falkirk Council Pension Fund

Falkirk Council Pension Fund was formed in 1996 inheriting the assets and liabilities of the Central Regional Council Pension Fund. Between March 1996 and March 2018, the Fund's asset value has grown from £385 million to £2.3 billion.

Membership numbers at 31/3/2018 were as follows:

Active members	-	15,271
Deferred members	-	5,831
Pensioner members	-	10,242

Clackmannanshire, Falkirk and Stirling Councils, along with SEPA, SCRA and Forth Valley College make up 90% of the membership. 26 other employers who make a contribution to public services within Central Scotland are also participants in the Fund.

Falkirk Council is the administering authority of the Fund and has delegated all pension matters to its Pensions Committee. Various operational functions have been further delegated to the Chief Finance Officer. The Fund has its own Pension Board and both Committee and Board include member and employer representation.

As at 31/3/2018, the funding level was 91%, with employer contribution rates for the three Councils in the Fund averaging 22% of pay.

Annual investment returns over the three and five years to 31/3/2018 have been 7.9% and 8.8% ahead of the Fund benchmark for these periods by 1.1%.

The Fund has formed a partnership with the Lothian and Fife Pension Funds in order to work collaboratively on investment matters. Under this arrangement, each Committee sets its Fund's investment strategy and delegates the implementation of strategy to a senior Officer who receives advice from a panel of investment professionals.

Administration at Falkirk is undertaken by an in-house team.

Further details about the Fund can be found at www.falkirkpensionfund.org.

This response to the consultation has been jointly approved by the Council's Pensions Committee and by the Pension Board of the Fund.

CONSULTATION QUESTIONS

Question 1: Retain the current structure with 11 funds

a) 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?*

  As a Committee and Board, we understand that Investment costs cover a range of elements including management fees, transaction costs, foreign exchange and performance fees. Getting under the bonnet of costs is highly complex as witnessed by the succession of initiatives launched for the LGPS since the publication in 2014 of CIPFA's guidance on *Accounting for Local Government Pension Scheme Management Expenses.*

  Thus far equity managers have been encouraged to sign up to an agreed Code of Transparency (all of Falkirk's equity managers have done so) and this has enabled equity costs to be analysed in line with the guidance. A more granular cost template covering most asset classes, including private equity and infrastructure, is currently being developed by the England and Wales Scheme Advisory Board (SAB) and the Financial Conduct Authority (FCA) and should improve cost transparency.

  Some cost information is disclosed in the Falkirk Fund's accounts but there is a need for accounting bodies to be more certain in relation to their disclosure requirements. (Recent years has seen disclosure range from including hidden costs to excluding them). Falkirk has in the past participated in a cost benchmarking exercise (and is in the process of doing so again using research specialists CEM benchmarking). It has also undertaken an analysis of FX costs. This was done as part of a joint exercise with Lothian Pension Fund using the specialist expertise of their in house team.

  Falkirk 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, so greater consistency is required.

  It is recognised that the granular analysis of costs requires expertise both at the input and output stages and therefore has its own resourcing and cost implications.

  This is very much a live issue for Funds and was the subject of a presentation at a recent seminar for Committee and Board members from across Scotland (n.b. this was part of a series of training events for Committee and Board members organised collaboratively by Fund officers and held annually since 2015 years).

- *How well does the current system manage investment costs?*

  The existence of successive initiatives as mentioned above indicates that there is a need for better oversight and governance of costs. That the activities of asset managers have not been perfect was highlighted in the FCA's 2017 *Asset Management Market Study.* This found that there was

  - weak price competition (profit margins of 36%, albeit mainly at the expense of

retail clients)
- lack of alignment between performance and costs
- a lack of cost awareness amongst some investors

Collaboration (and the aligning of strategies) should allow the negotiation of better rates from asset managers and partly address some of the issues raised by the FCA.

The structure of the LGPS with its accountability to local Committees and Boards should allow there to be a strong regime of oversight, however this depends on the ability to obtain meaningful cost information. The templates should assist with this. The procurement regime within local government means that there is a focus on best value and fees in any manager tendering process.

Whilst acknowledging the current cost transparency shortcomings, this is not attributable to the current structure within the LGPS, although larger Funds certainly have more resources to focus on this area.

Investment products/vehicles with high fees do not necessarily produce poor net returns. If that were the case, Funds would not invest in private markets.

- *How would you improve the measurement and management of investment costs in the current system?*

A recommendation of the 2017 FCA 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

Falkirk is supportive of these recommendations.

Opacity of investment costs is not only a problem for LGPS Funds but for the wider pensions community generally. By adopting the above recommendations the LGPS community will generally be ahead of non-public sector pension arrangements.

Given that certain asset classes are more expensive to access than others (e.g. private markets), it must be recognised that what is important is the overall value delivered (measured in terms of return and diversification) rather than cost itself, although it is clear that high costs and unnecessarily complex cost structures do appear to enrich managers at the expense of Funds.

b) Governance:

- *How well informed do you feel about the governance of your fund? What information do you rely on to measure this?*

  Information on governance is contained on the Fund website and in the Fund's Annual Report. Governance is an important feature of member training and is invariably covered at the Fund annual conference and in reports to the Committee and Board.

  Committee and Board meet on a quarterly basis and are provided with a variety of reports to enable them to discharge their respective roles. Committee have full access to officers, whilst further reassurance can be taken from the framework of advisers and auditors.

- *How well is the current system governed?*

  The current system of governance involves a lead Council acting as the administering authority of a Fund. Decision making is invariably delegated to a Pension Committee with varying degrees of further delegation given to Officers. The arrangement means that the lead Council must have a majority of seats on the Pensions Committee which curbs the scope for representation from other employers.

  There has been an improvement in oversight with the establishment of Pension Boards. However, the overall governance is weakened by the time pressures on elected members (given all their other responsibilities); the potential for member turnover due to the electoral cycle; and capacity for members to absorb the wide range of complex pensions matters requiring consideration.

  The last decade has seen some extension of member and employer representation within the governance structure, although the extent of the representation remains variable across Funds and at the discretion of the lead Council.

  A review was undertaken by KPMG in 2016 to consider how effectively Boards (including the Scheme Advisory Board) were functioning. The findings recommended improvements in training and guidance for Boards in order to ensure that their focus was on their oversight role. This clearly chimes with the importance of all those charged with governance (Committees, SAB and Local Boards) having the requisite skills and knowledge.

- *How would you improve governance of the current system?*

  Make employer and member representation on Committees mandatory but allow the lead Council to maintain a majority.

  Require Committees to have an independent trustee cum adviser.

  The electoral cycle can mean that there is an unhelpful turnover of Committee and Board members. Ideally, with a subject matter as complex as pensions, there should be continuity to allow knowledge to be built up. Administering Authorities should be mindful of this when making Committee and Board appointments.

Additionally, the needs of the Pension Fund are not always aligned with those of the Administering Authority or Other Fund Employers (e.g. the Fund may need to recruit at times of a wider Council recruitment freeze).

- *How important is it to maintain a local connection with respect to oversight and strategy?*

  The local connection is important for democratic accountability as the Scheme and the Funds are supported by local taxpayers. It is also helpful towards:

  - Fund strategy being aligned with the needs of stakeholders
  - Employers and Unions being more closely involved in the governance, and
  - scheme members having visibility of and ease of contact with their local Fund

- *How would you determine if the benefits of a local connection in governance outweigh the benefits of scale?*

  The need to maintain accountability to those who pay for the Scheme is paramount However, we do not agree that benefits of scale can only be realised if local connection is lessened.

  It would be possible to move to an enlarged structure and retain a local connection. (e.g. the merger of 2 or 3 Funds governed by a Joint Committee or the creation of a bespoke Pensions Authority governed by elected members from underlying Councils). Even with collaboration, local connectivity can be maintained and some benefits of scale achieved – as evidenced by Falkirk's collaboration with Lothian.

c) Operating risks:

- *How well informed do you feel about the operating risks of your fund? What information do you rely on to specify and measure these?*

  The Fund has a risk register which is reviewed by the Committee and Board at least on a two yearly basis with items of heightened risk being brought to the attention of the Committee and Board each quarter. The risk register is also reviewed through the internal and external audit process.

- *How well are operating risks managed in the current system?*

  The Falkirk Fund has a system of internal controls, including oversight from Committee and Board, internal and external auditors, actuaries and independent specialist advisers. The Council also operates a Whistleblowing Policy.

  The Fund has an internal resource consisting of 5 senior officers with skills and knowledge in scheme administration, payroll, funding, governance, investments and accounting. The Fund uses a Pensions Administration and Payroll System from a leading software house experienced in LGPS activities.

  In relation to investments, the Fund partners with Lothian Pension Fund in order to have share in and have access to a broader investment resource. The Fund's external investment managers are subject to their own audit arrangements and are required to produce annual assurance and compliance statements.

The number of investment officers employed by Funds (ignoring Funds with internal investment expertise) seems low in comparison with the volume of assets at risk.

- *How would you improve the measurement and management of operating risks in the current system?*

  Certain 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). Simplification of regulations would help.

  Funds to have succession plans formulated.

  Improved standards of data analysis to better inform Scheme Advisory Board. A training policy for members of the Scheme Advisory Board to ensure that they have requisite skills and knowledge in line with Myners principles. Have attendance at meetings and training undertaken reported in SAB Annual report.

d) Infrastructure:

- *How well informed do you feel about your fund's investments in infrastructure? What information do you rely on?*

  The Falkirk Fund has been investing in infrastructure as a distinct asset class for around 7 years. Initially this was with a global Fund of Funds manager. Latterly, since 2014, this has been in conjunction with Lothian Pension Fund, leveraging on their in house expertise to execute deals in the UK and (to a lesser extent) in European and other Global markets.

  Under the Fund's governance model, the Committee determines the asset allocation to infrastructure and delegates the strategic implementation to officers. Manager reports and return information is made available to Committee and Board on a quarterly basis. More detailed analysis of the portfolio is undertaken by a panel of investment professionals in line with the governance model. 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?*

  Under the current system, Infrastructure assets can be accessed through a Fund of Funds structure which (as Falkirk have 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. In addition, there is potentially a lack of alignment between a Fund's long term strategy to meet its liabilities and the "buy and flip" style of some infrastructure managers. Ultimately, whilst larger Funds may be able to allocate to a segregated mandate, Fund of Funds may be the only way that smaller LGPS Funds can gain access to infrastructure assets given that the more direct approach involves:

  - having the capacity to source, analyse and execute deals internally
  - having the capacity to resolve the legal and tax issues that will arise, and
  - having sufficient market presence and credibility to be offered investment

opportunities in the first place at an attractive price.

Falkirk has only been able to invest in the more direct manner through building up its collaboration with the Lothian Fund. This has enabled Falkirk to make around 20 investments directly with specialist managers totaling around £100m. The investments include a number of Scottish / UK assets including utilities, distribution networks, renewables, transportation concessions and water companies.

- *How would you increase investment in infrastructure in the current system?*

The legal position is that Funds do not exist to facilitate infrastructure investment but to pay benefits and defray employer costs.

Infrastructure investment should only take place where this fits with a Fund's objectives and strategy. Increasing infrastructure should not be an objective in itself.

Where it is consistent with Fund strategy, investments should only be made if they have the requisite risk, return and governance characteristics.

The Scottish Government's work with the SFT has been an interesting development and may eventually produce an investable product for some Funds. Infrastructure is a complex and illiquid asset and not without risk (as evidenced by the demise of Carillion and the collapse of the Morandi Bridge in Genoa).

e) Do you have any additional comments about this option?

The current structure is well known and has generally delivered for the LGPS Scotland. Any move away from it towards pooling (and to a lesser degree) merger is a risk.

Having said that, "trustees" have a duty of care towards members and employers to ensure that their needs and requirements are being properly served. This includes making sure that the Fund has the ability:

- to provide and maintain its service
- to meet statutory and regulatory requirements
- to invest fund monies competently
- to mitigate key person risk and have systems resilience
- to recruit staff required across a range of disciplines

The current structure suits the larger Scottish Funds better in terms of them being able to employ greater expertise, 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, compliance and risk management.

As a whole, the Scheme faces significant challenges – generating returns, keeping contributions affordable, dealing with complicated legislation and the demands for better standards from the Regulator. ESG, Voting, Cyber Security, Class Actions, Foreign Taxation, Accounting Standards are all further challenges. All of these issues will persist irrespective of the structure. They are, however, likely to be addressed more effectively in an enlarged structure – merger or collaboration - where scale would allow a specialist and better resourced service to be developed.

Question 2: Promote cooperation in investing and administration between the 11 funds

a) 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). Considerable work in this direction has already been done through the use of National Frameworks for services such as actuarial, investment consultancy and custodian services.

  Further savings would be achieved if Funds are able to tap into an internal investment resource, although stringent regulatory (FCA) standards apply as well as the need to remunerate specialist staff having regard to private sector rates.

- *What would be the positive impacts?*

  Savings on investment costs; ability to access a wider range of asset classes; improved implementation of strategy; and better performance analysis and understanding of risk.

- *What would be the negative impacts?*

  For collaboration to work there would have to be benefit to all the Funds in the relationship (e.g. a financial contribution from the smaller funds to enable the shared resource to be built out).

b) 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. Our 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).

- *What would be the positive impacts?*

  There would be opportunities for funds to share resources; learn from each other and implement best practice.

- *What would be the negative impacts?*

  Having the experience of collaborating with Lothian, the reality is that decision making on collaborative matters is more complicated than non-collaborative matters. This is not unexpected. Reaching definitive positions or simply organising meetings to suit collaborators can be challenging). The more Funds involved then the more complicated it becomes. In other words, there are limits to the collaborative model.

c) 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 resilience.

  There is already a very good network across the Scottish LGPS for the sharing of information and ideas (i.e. the IGG and SPLG groups). There are quarterly meetings of the group and email exchanges on a variety of issues as they arise.

- *What would be the positive impacts?*

  Some Improvement in risk management. Collaborations can evolve at the pace most suited to the needs of the Funds concerned, but given the lack of incentive for change may lack impetus.

- What would be the negative impacts?

  The reduction in key person risk is limited insofar that a smaller fund cannot expect a larger fund to be resourced simply to meet any adverse circumstances that it may encounter.

  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.

  Collaboration under this option is voluntary, so Funds will be under no compulsion to collaborate and some Funds will be more interested than others.

d) 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.

- *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.

- *What would be the negative impacts?*

  No negative impacts other than local resource requirement not to be underestimated for smaller funds and the need to find a willing collaborative partner.

e) Do you have any additional comments about this option?

Collaboration requires the investment of time and effort by the parties involved; a shared vision; and a willingness to align investment strategies and beliefs.

Falkirk’s experience of entering into a collaborative agreement with Lothian has been positive enabling the Fund to make £100m worth of investments into around 20 different vehicles.

In terms of wider collaboration, the Scottish Funds have always had positive working relationships and there is clearly an appetite for this to be extended. 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 – proving that collaboration can happen.

Question 3: Pool investments between the 11 funds

a) Cost of investing:

- *What impact do you think pooling investments between funds would have on the cost of investing?*

  A modest one.

  Asset pooling should result in cost savings through the benefits of scale - managers currently offer lower fees if assets invested exceed particular thresholds.

  One of Falkirk's external managers, has provided an example of this whereby a global equity strategy might cost 0.54% for a £100m mandate but 0.39% for a £1b mandate.

  Pooling in England and Wales would appear to have made managers more competitive. Further cost transparency initiatives should help in this direction. It could be said that Scotland is already benefiting from this without needing to pool assets.

  Savings will take years to manifest themselves and may well end up being eroded by the set up, transition and governance costs.

  Arguably, greater savings could be achieved from an enlarged Fund structure and from building up internal management resources

- *What would be the positive impacts?*

  Cost savings (eventually) and, for smaller funds, the chance to invest in a broader range of asset classes.

- *What would be the negative impacts?*

  Cost savings are likely to take time to be realised and ultimately are not guaranteed.

  Uncertainty. It is too early to assess from England and Wales pooling whether the savings will justify the disruption and bureaucracy that the pool structure brings. Proof of concept remains to be established.

  The main driver of Fund return is its strategic asset allocation rather than manager selection. Under pooling, the asset allocation decisions would remain with a local Fund. Consequently, the overall impact of pooling in terms of overall returns is likely to be limited.

- *If asset pooling were possible, under what circumstances should a fund consider joining an asset pool?*

  If, having recognised the governance challenges, two or more Funds felt that their investment objectives could be better achieved through a pool.

- *Under which circumstances should the SLGPS consider directing funds to pool?*

  Not convinced this is an option that should be imposed on Funds.

b) Governance:

- *What impact do you think pooling investments between funds would have on governance?*

  Governance would become more cumbersome as the creation of pools would result in an added layer of bureaucracy between Funds and investment managers.

- *What would be the positive impacts?*

  There is the prospect of more skillful investment decision making (i.e. better manager selection and oversight), although this depends on Scottish Pools being able to resource up successfully – not a given - both in terms of attracting the appropriate quality of staff / pool board members whilst maintaining costs at an acceptable level.

- *What would be the negative impacts?*

  The additional layer of governance introduced by pooling and the practical ramifications.

  As Pools are managing monies on behalf of Funds this brings them under the purview of the Financial Conduct Authority, whereas Funds are subject to the statutory rules. This is likely to create tensions.

  There may be difficulties between pools and funds as to who has responsibility for aspects of asset allocation. Nominally this is the role of the Fund but how far down the asset chain does this go (e.g. would a Fund be able to make a specific allocation to a UK Equity Value mandate or would it be confined to allocating to UK equity or only Listed Equities as a whole?). The more granular the asset allocation by the Fund the less scope for scale benefits (and savings) that the pool will have.

  There may be difficulties between pools and funds as to who has responsibility for ESG matters. Different Funds in the same pool may have differing investment principles. How can this be efficiently undertaken by the pools?

  There has been no consistency around the way in which pools have been set up in England and Wales. They differ in size from £15bn to £40bn and there are at least 5 different operating models. All of which serves to illustrate the rather experimental nature of the initiative.

  It is not clear how long it will take to transition all Fund assets to the pools – possibly 10 years – and the process has already been running for a number of years.

c) Operating risks:

- *What impact do you think pooling investments between funds would have on operating risks?*

Having a qualified and experienced Pool Board should lead to better oversight of the manager selection process. To the extent that Funds are exposed to key person risk, then pooling would be a mitigating factor. (n.b. other mitigating alternatives exist which do not carry the same governance or structural risks as pooling).

- *What would be the positive impacts?*

  Better oversight of manager investment activities with manager selection and monitoring being transferred to an entity with appropriate investment knowledge and understanding.

- *What would be the negative impacts?*

  Fund Committees would be distanced from their underlying investments due to the extra layer of governance represented by the Pool.

  The establishing and maintenance of pools (including their legal structure, staffing, interaction with Funds, etc) would be a substantial undertaking and a major distraction from the daily business of running the Funds.

d) Infrastructure:

- *What impact do you think pooling investments between funds would have on funds' ability to invest in infrastructure?*

  A number of Scottish LGPS Funds already invest successfully in infrastructure, so for those Funds pooling would have a limited impact.

  Pooling may allow Funds to invest in larger scale infrastructure assets, but these may not necessarily be suitable for Scottish Funds in terms of their risk and return characteristics and diversification needs.

  Pools in England and Wales will only be turning their attention to alternative assets (incl. infrastructure) once more mainstream assets have been transitioned. Therefore, the benefits of scale investing in infrastructure may take some to materialise.

- *What would be the positive impacts?*

  Opportunities for smaller funds to gain exposure to asset class.

- *What would be the negative impacts?*

  A pool approach to infrastructure may not align with the investment objectives of a local Fund (e.g. a local Fund may wish to target infrastructure with higher return characteristic than the pool or vice versa).

e) Do you have any additional comments about this option?

Pooling has its advantages in terms of probable cost savings, added resilience, the expertise of the Pool Board and the potential for scale investment in infrastructure. However, the model is untested, clouds governance responsibilities and creates a new tier of bureaucracy. It is a live and long term experiment, which, anecdotally, appears to be throwing up practical difficulties between the Funds and the Pools. It would be disruptive and could adversely impact Fund members, pensioners and other stakeholders. On balance, Funds and their stakeholders should not be exposed to this risk.

Question 4: Merge the funds into one or more new funds

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a) Cost of investing:

- *What impact do you think mergers between funds would have on the cost of investing?*

  A positive impact. A merged Fund could expect to secure lower fees through its increased buying power.

  The Falkirk Fund has assets of £2.3bn. Even a modest reduction in fees of 5bps would translate into a saving of around £1.2m per annum which with the benefit of compounding over a number of years would not be immaterial.

  Savings would not be achieved immediately or even realised from every asset class (as fees, such as illiquid infrastructure assets, may be fixed for the long term). Nonetheless, savings could potentially be realised each time a mandate was being let or re-let.

- *What would be the positive impacts?*

  Any fee savings would help with fund solvency and feed into a stronger funding base or lower employer rates

  Better control of costs through an enlarged structure being able to devote greater resource to this complex area.

  Better investment governance through the larger entity being able to afford and attract more specialist expertise.

- *What would be the negative impacts?*

  Once merged, there would be transitioning costs as a result of investment strategies being re-aligned. However, these could be spread over time as and when mandates came up for renewal.

- *If merging were possible, under what circumstances should a fund consider a merger?*

  Where there was likely to be benefits to the stakeholders of the merging Funds. However, in order to provide certainty and permanency of the arrangement, any merger should be set out in statute and not just the result of a local agreement between Funds.

- *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 stakeholders (i.e. scheme members, pensioners and employers). That said, merger may not be the optimum solution for all the existing funds.

b) Governance:

- *What impact do you think mergers between funds would have on governance?*

  A major impact.

  Decisions would have to be made around the governance arrangements for the merged structure.

  In order to deliver democratic accountability and provide adequate stakeholder representation in line with previous SPPA guidance, a Joint Board solution or the creation of a bespoke Pensions Authority could viable models. This would especially be the case with a bespoke Pensions Authority, which would enable Committee representation to be drawn from the widest range of participating employers. A bespoke Pensions Authority would have a degree of autonomy from any single Council and would have scope to set its own policies as service needs dictated. An existing example of this is South Yorkshire Pensions Authority which was created out of a merger of Metropolitan County Council Funds in 1988.

  Consideration would also have to be given to the extent of merger (i.e. 1, 2, 3 or more "superfunds"). On balance, one Fund feels like an over concentration of risk. One Fund would also mean incorporating the Strathclyde Pension Fund into a larger Fund when it contends that it already has sufficient scale to operate successfully. A three Fund structure would enable stakeholders to enjoy the benefits of increased scale; still allow a degree of geographical connection to be maintained and avoid an over concentration of operating risk in one Fund. Limiting the amalgamation of funds to 3 or 4 of the existing funds would also be more manageable (and less risky) than trying to amalgamate 11 funds in one fell swoop.

- *What would be the positive impacts?*

  Compared to collaboration and pooling, a merged structure would bring greater clarity and certainty of decision making as there would be a single Fund strategy and single set of investment principles. With pooling, there will clearly be tensions between Pools and Boards. Even with collaboration, differences could still exist between Funds around investment objectives and beliefs, making governance cumbersome and decision making less effective.

  There would be fewer Pension Committees and fewer Boards so more streamlined arrangements and reduced duplication of effort. Arguably there would be a better chance for Committees and Boards to be "staffed" by members with appropriate skill set (leading to a reduced risk of things going wrong).

- *What would be the negative impacts?*

  Reduction in the number of members in oversight roles – if things go wrong, they could go wrong "big".

  More employer/stakeholders to be accommodated (n.b. albeit the Strathclyde Fund appears to cope ok with this challenge).

c) Operating risks:

- *What impact do you think mergers between funds would have on operating risks?*

  It should reduce operating risk.

  With a larger entity, there would be the opportunity to build a best in class resource covering the wide variety of specialisms required 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 (e.g. employer relations, IT, procurement, web presence) underlining the challenge for small and medium sized funds to cover all the bases.

- *What would be the positive impacts?*

  Better outcomes for members and employers.

  Reduced risk of non-compliance.

  Potential for better risk control e.g. key man risk

  Potential to offer employers more sophisticated solutions (e.g. alternative investment strategies)

- *What would be the negative impacts?*

  Scheme members could feel more remote from decision making, hence the importance of the getting the culture and customer care service levels correctly positioned and monitored.

  Scheme members could also be suspicious around motives for fund mergers - wary of it being the first step in a "cash grab" (so a robust and transparent governance system would be crucial).

d) Infrastructure:

- *What impact do you think mergers between funds would have on funds' ability to invest in infrastructure?*

  A merger would enable the enlarged funds to access larger scale infrastructure projects, although **a)** such large scale projects may not necessarily be appropriate for the Funds to invest in (in terms of risk, return and price) and **b)** Falkirk has been successful in making investments of around £100m through collaboration with Lothian. In short, merging the funds to achieve more investment in infrastructure (which is not a fund objective), is not a sufficient basis alone to merge.

- *What would be the positive impacts?*

  Potentially an increased investment opportunity set (but see next bullet).

- *What would be the negative impacts?*

Bigger chunks of capital to be deployed – this may curtail opportunities.

e) Do you have any additional comments about this option?

Merger delivers:

- a strong system of governance
- strong investment decision making
- the potential for substantial cost savings
- fairness for employers (as funding positions can continue to be tracked with no cross subsidies)
- a secure structure for scheme members which mitigates key person risk and improves overall resilience
- a cost effective structure for employers
- potentially wider representation for employers in the governance arrangement

Question 5: Preferred and additional options

a) Which option does your organisation prefer? Please explain your preference.

Fund Merger with 3 “SuperFunds” being created based around the existing Strathclyde, Lothian and North East Funds. A structure of this type would:

- allow the merged funds to benefit from scale investing
- deliver a strong and efficient system of governance
  - each SuperFund would be a single decision making entity
  - there would be no need for an additional layer of bureaucracy as with the pooling option
- allow centres of pensions expertise to be developed across all facets of fund activity including administration, funding and investment management for the benefit of employees, pensioners and employers alike
- enable the local government pension scheme to maintain local accountability
- assist small and medium sized funds with compliance and resilience issues

A merged structure could still include local administration hubs if a “closer to customer” service was desirable. This would have the comfort of operating under the umbrella of a merged structure.

It is noted that Fund mergers have successfully taken place before (e.g. the local government re-organisation of 1975 when County Council funds were merged with Town Council funds). The creation of South Yorkshire Pensions Authority is a further example.

b) What other options should be considered for the future structure of the LGPS?

If Fund merger is not mandated, then Funds should be encouraged to continue their efforts in developing collaborations with other Funds. This would however mean a lack of uniformity across the Funds with collaborations all at various different levels and stages. There would also have to be an acceptance that by maintaining the 11 Funds – albeit with some collaboration - costs would most likely have to rise to allow smaller and medium sized funds to properly address their ever increasing compliance, resilience and regulatory obligations.

In relation to pooling, the Fund does not support this option because of:

- the additional layer of bureaucracy resulting in a lack of governance clarity
- the untried, experimental nature of pooling and the consequential risk
- the expense and overhead of setting up and operating the pools

c) What would be the advantages and disadvantages of these other options for funds’ investment costs, governance, operating risks and ability to invest in infrastructure?

The respective advantages and disadvantages of the various options have been set out in responding to Questions 1 - 4 of the consultation.

d) Are there any other comments you would like to make?

We agree with the Strathclyde Pension Fund that the Scottish LGPS has been a success story. The Scheme has delivered excellent benefits for a large swathe of the population over a long number of years. Membership levels have remained robust and are a sign of confidence and trust in the Funds. Funding levels have improved and compare favourably with the English and Welsh Funds. There has also been a good track record of Scottish Funds working together to share ideas and develop best practice.

That does not mean that the structure of the scheme is optimal, nor that the structure should be moribund and unchanging. Set against the positives outlined above, employer contributions rates are high at a time of extreme pressure on public finances and Funds are constantly grappling with the complexities of the ever changing pensions environment.

With up to 10% of the Scottish population having a stake in the Scheme, it is essential that the structure enables the Scheme to deliver effective outcomes for all of stakeholders in an increasingly complicated and regulated pensions world.

In our view, it is essential that the options for the way forward are evaluated against clear objectives – the need to provide a stable, secure, high quality service for scheme members and an efficient, well governed and affordable Fund for employers and Council taxpayers. In other words, the structure should be the one that delivers best outcomes for the stakeholders.

As a medium sized Fund, Falkirk considers that the interests of its members and employers are likely to be best served by merging with another Fund. As the Falkirk Fund already has strong ties with the Lothian Fund (including collaborative infrastructure and private debt investments and investment manager monitoring), that would be Falkirk's choice of partner Fund.

As intimated previously, if merger is the chosen solution, then in order to provide certainty and permanency of the arrangement, this should be mandated in statute and not merely be the result of a local agreement between Funds from which either party could retreat.

It is recognised that if merger is pursued, a significant body of work would require to be undertaken by the Scottish Government, SPPA and the Funds. This could however be scheduled over a sensible time period taking account of day to day demands on "trustees" and officers. Fundamental would be "getting the governance right" in order to have an end product that married technical knowledge with clarity of decision making, accountability and broad stakeholder representation.

Overall, the effort required should not be underestimated, but the long term stability of the Funds and sustainability of the Scheme is a prize that is worth the effort.