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Dear Dr Roy,

SLGPS Structure Review

Thank you for the opportunity to participate in this important consultation on the future structure of the Scottish Local Government Pension Scheme (SLGPS). It is notable that amongst those who may respond to this consultation there are vested interests, including those involved in SLGPS governance, officers, advisers, investment managers and other providers, many of whom could be adversely affected if the SLGPS structure changed.

As a single national scheme delivering pension benefits according to regulations set in statute, the structure should not affect member benefits directly. Changes to the structure could, however, affect an employer such as Scottish Water, impacting future contributions by affecting investment returns and funding through changes to costs and efficiency. The overall funding positions of the SLGPS funds are currently healthier than those in England & Wales, but this does not mean there is no room for improvement and any inefficiency should be considered and addressed, with enhanced long-term sustainability of the scheme being the goal.

With this in mind, effective and efficient governance of the SLGPS pension funds is central. Such governance needs to regard the fiduciary duty of the SLGPS to its members and employers as the primary concern. This applies to the question of infrastructure investment as it does to any other asset allocation, where the best interests of employers and members must guide investment decisions. It is notable that a number of the SLGPS funds do already hold significant investment allocations in infrastructure.

In addition, accountability is critical in governance of the structure, not just to employers and fund members but to representatives of local taxpayers, who for many employers are the final guarantee behind the SLGPS benefits. A future governance structure also needs certainty of access to personnel able to dedicate sufficient resources and with the requisite levels of expertise/experience, to effectively administer the fund.

Option 1 – Status Quo
It should be clarified that there is no single status quo governance position across the 11 SLGPS funds, with each body over the years responding to the needs of its membership and required investment outcomes. Such variation has also been driven by the significant differences in size of funds by investment value, from over £20bn in the largest fund to a few hundred million pounds in the smallest.

This has by necessity required different approaches to investment management and its governance, but also means that information on the performance of the overall SLGPS is unclear. Directly comparable data on investment costs from individual funds is lacking and this has hindered previous reviews of the SLGPS structure. While all funds would undoubtedly support investment cost transparency and are subject to scrutiny through published audit exercises, the lack of consistency of information from investment managers makes it difficult for employers and other stakeholders to judge the effectiveness or efficiency of the Scheme as a whole.

As a result, the strongly held suspicion is that the current structure is inefficient. Investment benefits from scale and broadly speaking, larger funds can achieve lower fees while having access to greater investment opportunities. The combined SLGPS is smaller than some of the largest UK pension funds and pales in comparison to the biggest funds on the international pension stage, where fund sizes equivalent to hundreds of billions of pounds are common. Possibly with the exception of Strathclyde Pension Fund (c£21 billion), all other SLGPS funds could benefit from greater scale. It is worth noting that the current exercise to generate combined LGPS investment pools in England & Wales could create multiple investment groups, each equivalent in size to the whole of the SLGPS.

Aside from potential scale gains in investment efficiency, governance of the SLGPS is also inefficient in terms of the resources currently required. In the region of 150-180 people are involved in the Pensions Committees and Pension Boards across Scotland, many with limited knowledge and experience of pension matters despite the best efforts of funds to provide appropriate training. It is a fact that while the involvement of Councils as administering authorities for SLGPS funds allows for some local accountability in fund decision making, this does also bring governance issues in the form of potential conflicts of interest for elected members and fund officers. It also means that elected committee members who may only have been through a single fund valuation cycle, can find themselves unelected and replaced with new members who have to start learning about pensions from scratch.

In smaller funds, there is also significant risk from reliance on relatively small numbers of people within local authorities who have the requisite pension knowledge, which in turn creates heavy reliance on external suppliers. This can mean that some funds are reliant on investment advice from the same suppliers who are selling them investment management services. The conflict of interest is clear.

Employer contributions required to meet the costs of the SLGPS have risen significantly in recent years, at the same time that duplication of effort across the Scheme is clear. Employers such as Scottish Water who participate in more than one fund experience different ways of interacting with fund administration, different KPIs for fund services, different requirements for data formatting and submission, different levels of member communication support, etc., which all creates inefficiencies.

Option 2 - Greater Collaboration

Scottish Water has had some experience of this option in recent years through its participation in the Lothian Pension Fund, which, through its FCA authorised company advises other funds and works with them to address key staff risks and develop trust within the current structure. Collaboration with funds that have similar investment objectives and principles is positive in that resource, knowledge and costs can be shared. The arrangements are expected to evolve and for benefits to become available from greater investment scale as trust grows and the funds are prepared to enter into larger parallel investments.

However, the governance of such collaboration is complex. All funds in the arrangement need to continue to be resourced appropriately to make decisions for their respective fund beneficiaries. The simple logistics and co-ordination of stakeholders in order to make decisions seems to grow complexity at an exponential rate, to the degree that Lothian Pension Fund estimates it has reached the limits of a workable governance structure when collaborating with only two other funds. Making investment decisions requires 12-15 people from different authorities to reach an informed agreement within the joint investment strategy panel (a small sub-set of the full committee and board membership). This is a purely practical limit based on the governance and decision making still required under collaboration, rather than any financial or investment management limit reached due to the combined value of funds.

Therefore, relying on greater collaboration across a larger number of funds (or all funds in the SLGPS) would seem to very quickly reach practical limitations on the generation of efficiencies and may in fact slow decision making to the extent that investment opportunities are missed or governance becomes unwieldy. Scottish Water would be concerned that this option for a future structure could be advocated simply to avoid more complex changes with greater potential for more significant efficiencies.

Option 3 - Pooling
This option is currently being implemented in England & Wales, where the government has advocated this approach but left it to individual funds to work out the best means to achieve it. It is really too early to say whether pooling actually works and in the short term, the effect has been to see some pools achieving what is thought (as a rule of thumb) to be the minimum size for investment scale advantages, approximately £25bn, while others are still well short of this figure.

The governance required for pooling also places an additional administrative layer between funds and their investments, to ensure that decisions made at the pool level are subject to proper oversight. This creation of new pool investment management roles has seen some funds losing their most experienced and valued employees, as pools are prepared to out-pay the local authorities to secure the necessary skills and knowledge. Consequently, funds themselves may be struggling to maintain even their previous levels of governance and informed accountability within pension committees.

Whilst pooling would be expected to reduce investment costs through scale, there is as yet still a lack of clarity in the decision making process between funds and the investments they own within a pool. The extra layer of governance means that additional costs are likely to be introduced into the Scheme through this route, which would need to be outweighed by greater investment returns or efficiencies in investment management fees.

Creating larger investment pools may make it easier for funds to access infrastructure investments, where funds acting alone may not have the expertise or scale. However, given the concerns raised by the pooling exercise in the rest of the UK, Scottish Water would not favour this approach to the SLGPS.

Option 4 - Merger
From an employer perspective, the concept of interacting with a single SLGPS fund through a single set of processes is attractive.

However, it should be noted that merger would have to overcome a number of challenges, many of which are associated with the administrative scale and need for effective governance and engagement of all stakeholders, including employers and members. Such engagement would include representatives from councils and other employers that do not currently administer the funds, disrupting the existing model where local councils take on the role of scheme managers.

Merger would also have to be based around the best practices of current funds, including scale facilitation of in-house investment and full fee transparency where external investment management is necessary. Investment decision making would also have to be subject to effective delegation, so as to overcome the governance issues highlighted above under the options for collaboration or pooling.

Importantly, the funding of individual employers would need to be protected so that there are no cross-subsidies within the fund. Achieving this may require the covenants of smaller employers in particular to be underwritten in some way by the Scottish Government.

It should be possible for a merged single fund for the SLGPS to retain local service delivery. For example, the fund could maintain local offices in some or all of the local authorities that currently act as administering bodies, as would be necessary to engage with pensioners and deferred members who do not have a current employer through which they can interact with the fund. Smaller employers may also benefit from having a local source for advice on administration (which would in any case be greatly simplified by interaction with a single scheme).

Of the options put forward, merger, whether into a single fund or to a smaller number than the current 11, would seem the most likely to be able to deliver clear governance (without becoming overly layered in bureaucracy); economies of investment scale & fees; efficiency in administration; and a national consistency of service to members and employers.

Like all proposed new ways of doing things, care must be taken not to expect a change to immediately address all current concerns; and merger will require an initial cost outlay and upheaval of the status quo. That will be against the interests of stakeholders both within the SLGPS structure and those private sector companies that gain from fees charged to multiple Scottish funds for advice and investment management.

It may be preferable for a merged fund to be managed independently of local authorities so as to avoid conflicts of interest for fund officers and elected officials. Governance of such a fund would need to be carefully constructed so that it did not become inappropriately exposed to pressures from political or other interest groups, which would hamper the fund manager in carrying out their fiduciary duty to fund members and employers.

On infrastructure

Our response is deliberately light on this specific question, largely because it is not clear from the consultation which definition of “infrastructure investment” is being used. As noted above, many SLGPS funds already hold significant investments in the asset class of infrastructure, which includes opportunities in Scotland, the rest of the UK and overseas. Furthermore, that investment is not necessarily in new-build infrastructure, but in developments where other investors have taken the initial risk for short term return and then sold on their stake to a pension fund that is primarily interested in steady, long term returns to address fund liabilities, such as can be provided by rental income from industrial units, offices or shopping centres.

A different view on infrastructure might be the provision of government bonds issued to raise funding for public infrastructure projects, with returns guaranteed in the longer term. That could be of interest to a pension fund looking to secure a steady income flow, but such investments would need to be assessed against other forms of government debt (gilts) or bonds available in the private sector. In this case, fiduciary duty remains paramount regardless of the size of the pension fund and the number of funds in place for the SLGPS.

In conclusion
Scottish Water is supportive of this consultation and of changes that may be made to the SLGPS governance and investment structures that would drive cost savings and operational efficiencies, to the benefit of the members and employers who between them pay for the scheme. From the options presented, we believe that to realise the necessary improvements then the change required will have to be a more significant departure from the status quo than would result from either collaboration or investment pooling. Given the level of vested interests from all stakeholders, we further believe that the Scottish Government may have to develop clear guidelines and timescales within which the existing funds will be tasked with making the necessary changes. Without this clarity and if left to the funds themselves to engage in an open-ended, purely voluntary transformation, the energy directed to this task may be insufficient to realise the benefits available.

Thank you once again for the opportunity to participate in this consultation and I hope the above points are seen to be a positive contribution to discussions.

Yours sincerely,

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Tax, Treasury & Insurance Manager

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