## 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](mailto:consultation@pensions-intitute.org) no later than **Friday, 7 December 2018**.  This consultation is being conducted in electronic form only, so **responses must be emailed**; hard copy posted or delivered responses cannot be received. Any queries about the consultation should be addressed to Matthew Roy, Fellow, Pensions Institute at matthew.roy@pensions-institute.org. |

**RESPONDENT DETAILS**

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| **Name of responding organisation(s)** Please list the full name of each organisation participating in this response. | **Organisation type** Is your organisation an administering authority, employer, or employee group? Please record for each responding organisation. |
| **Orkney Island 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. |
| **Gareth Waterson, Head of Finance, Orkney Islands Council** | **Confirm** |
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| **Date** Please date the response. | **04 December 2018** |

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| **Covering information** If you wish to include covering information with your response, please include the text here. The text can wrap onto additional pages if needed. |
| **Orkney Islands Council is the Administering Authority for the Orkney Islands Council Pension Fund.**  Key figures for the Orkney Islands Council Pension Fund at 31 March 2018 are as follows: -  **FUNDING**  At the 2017 triennial actuarial valuation, the Fund was assessed as 112.7% funded (114.4% at the March 2014 valuation).  All Employers participating in the Orkney Islands Pension Fund pay a common contribution rate that has been reducing in recent years:  2014/15 21.4%  2015/16 19.8%  2016/17 19.2%  2017/18 19.2%  2018/19 18.2%  2019/20 17.6%  2020/21 17.0%  **INVESTMENT PERFORMANCE**  1 – year: 8.9%  3 - years: 10.6%  5 - years: 11.1%  Since Inception: (1995) 9.7%  LGPS pension funds – Net return on investment 2017/18 (unaudited figures)    Source: - Audit Scotland. “Orkney Islands Council Pension Fund has achieved, for the second year running, the highest return on assets across all local government pension funds in Scotland.”  **Investment management expenses 2017/18**    Source: - Audit Scotland.  **MEMBERSHIP**    **EMPLOYERS**  The Fund invests and administers pensions on behalf of 7 current and former employers. These include scheduled bodies and admitted bodies.    **INVESTMENT ASSETS**  The value of the Fund at 31 March 2018 was £366.4 million (£335.3m at 31 March 2017).  The Fund is invested in a globally diversified strategy through a single fund manager. The Statement of Investment Principles was revised in November 2017 to reflect a review of Environmental, Social and Governance factors including a requirement for the Fund Managers to adopt the United Nation Principles of Responsible Investment. |
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The consultation questions follow.

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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 Orkney Islands Council Pension Fund is managed by a single fund manager that is a signatory to the LGPS Transparency code.  The investment costs are disclosed in the Pension Fund Annual Report and Accounts in sufficient detail that stakeholders should be able to gain a good insight into the cost of managing the pension fund and it’s investments:-    The Code of Transparency enables a greater understanding of the investment process and better cost management through the fund managers disclosure of transaction costs.  Total transaction costs for each asset class are detailed below:    The nature of the transaction costs groups are as follows:   * Transaction Taxes – Incudes stamp duty and any other financial transaction taxes. * Broker Commissions – Payments for execution services, including exchange fees, settlement fees and clearing fees. * Implicit Costs – Indirect costs associated with buying and selling securities, being an estimate of market impact. * Indirect Transaction Costs – transaction costs incurred within pooled funds when they buy and sell their underlying investments.   In addition to the transaction costs, the portfolio has incurred indirect fees of £284,570 paid from the Net Asset Value of the pooled funds.   * How well does the current system manage investment costs?   Investment management costs for the Orkney Islands Council Fund when viewed in isolation, have increased over recent years as the investment strategy has been developed and investment mandates have changed with the Fund Managers seeking higher fees commensurate with the more complex investment strategies. The investment costs are however only a part of the consideration and performance net of costs is the real measure of the value added by investment managers.  Despite the evolution of framework agreements and benchmarking arrangements, there is still no central and easily accessible resource that discloses the full range of investment mandates and fees charged to the LGPS that would allow Funds to shop around for the best fees.   * How would you improve the measurement and management of investment costs in the current system?   Following on from the development of the Code of Transparency and the disclosure templates, there may be a role for the Scheme Advisory Board to collate and publish an analysis of the investment costs of the different investment mandates being followed by the 11 Administering Authorities.   1. Governance:  * How well informed do you feel about the governance of your fund? What information do you rely on to measure this?   The Annual Report and Accounts of the Pension Fund are an important document in informing stakeholders about the governance of the fund. There is a section of the annual report that contains a Governance Compliance Statement giving an assessment of how the Fund measures up to best practice principles.  The Annual Report and Accounts of the Pension Fund are also subject to External Audit and the Audit Certificate on the Accounts and the Annual Audit report provide assurance that the Fund has sound governance practices in place. If there are governance weaknesses these are reported in the Annual Audit Report.  An annual assessment of the Orkney Islands Council Pension against the Local Code of Corporate Governance is also carried out to identify areas where improvements may be possible.   * How well is the current system governed?   The Governance of the LGPS in Scotland has not been a significant feature of any national overview reports from Audit Scotland. This would support the conclusion that there are not many systemic or inherent governance issues with the current system that are being reported at an individual fund level. The governance procedures have been bolstered over recent years with the requirement to prepare separate accounts and establish Pension Boards and Committees.  The Council believes that local accountability and oversight carried out by local elected members in decisions relating to the pension funds should remain a matter for local determination and that this ‘local’ ownership is crucial to effective cost control and sustaining good governance. The local nature of decision making guarantees an effective voice for employee representatives on pension fund boards, as well as that of employers. This local voice may be lost or diluted under aggregated, less local models of governance.   * How would you improve governance of the current system?   The Governance of the current system is believed to be strong but perhaps a national overview report by Audit Scotland highlighting areas where improvements could be made by individual funds would be beneficial.   * How important is it to maintain a local connection with respect to oversight and strategy?   It is very important for accountability of decision making to maintain a local connection with respect to oversight and strategy. If the Government were to decide on a Full Merger and a single fund for the LGPS in Scotland there would thereafter be a disconnect between the fund’s performance and the local authorities who are required to pay Employer’s contributions into the fund.  Any change to the current model that extended to pooling or merger could be seen as a weakening of local democratic oversight and governance of the pension funds.   * *How would you determine if the benefits of a local connection in governance outweigh the benefits of scale?*   The Orkney Islands Council pension fund is the smallest of the LGPS funds in Scotland yet according to Audit Scotland “Orkney has the highest funding level relative to other pension funds in 2017/18”. The Orkney Islands Council Pension Fund therefore retains the benefits of a local connection in terms of governance whilst it is difficult to see what benefits “scale “ would bring to the fund in terms of investment performance.   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?   The Orkney Islands Council pension fund has a risk register that is reviewed regularly.   * How well are operating risks managed in the current system?   The audit process has not identified any significant failings.   * How would you improve the measurement and management of operating risks in the current system?   All 11 Administering Authorities use the Heywoods Altair Pension software but on an individual fund specific basis. If the LGPS in Scotland had a common software platform that was cloud based it would be possible to obtain common reports that captured the statistical information from all funds giving much better management information. There may be a risk to this of concentrating all the administration data on one platform but as a cloud based platform the usual redundancies should be built in.   1. Infrastructure:  * How well informed do you feel about your fund’s investments in infrastructure? What information do you rely on?   The Orkney Islands Council Pension Fund has no direct investments in Infrastructure, the Investment Strategy set out in the Statement of Investment Principles is to invest monies in a prudent and diversified manner, in accordance with the Scheme regulations and in recognition of the inherent risks that accompany investment in various asset classes. The revised asset allocation and range guidelines that were applied with effect from February 2017 are shown in the Asset Allocation table below together with the actual asset allocation at 31 March 2018.     * How do you rate the current system’s ability to invest in infrastructure?   The principle impediment to investment in infrastructure for small funds is the lack of suitably attractive investment opportunities that are packaged in a manner that make them easy to access. For larger funds that have larger sums to invest there are significant infrastructure investments already completed.  The due diligence requirements, scale of investment required and high level of entry costs is definitely a deterrent to direct investment in infrastructure for small funds.   * How would you increase investment in infrastructure in the current system?   If there were a suitable investment vehicle that offered the pension fund a route into infrastructure investment with an appropriate return for the level of risk, that might be persuasive. It should also be recognised that Infrastructure by its very nature is long term and such an asset class may be more suited to mature funds that are seeking to match pension payments to secure steady cash flows. The Orkney Islands Council Pension Fund is gradually maturing but has not yet reached the point where it has to change its investment strategy to a matching approach.   1. Do you have any additional comments about this option?   Restructuring the Scottish LGPS simply to secure additional investment in Scottish infrastructure could be a hugely costly mistake. Those charged with stewardship of the LGPS require to invest the funds for which they are responsible to earn the maximum return possible for the level of risk taken. Just as investments in arms, fracking, fossil fuels etc may be controversial, if they are on balance the best investments to meet the objectives of pensions funds then that is where pension funds are invested. Government should therefore concentrate on developing a package of infrastructure projects that can be placed in a suitable “wrapper” to make investment in Scottish infrastructure an attractive option for the Scottish LGPS funds. |

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| Question 2: Promote cooperation in investing and administration between the 11 funds The text can wrap onto additional pages. |
| 1. Cost of investing:  * What impact do you think promoting agreements between funds would have on investment costs?   Increased purchasing power has the potential to lead to reduced investment costs as most investment managers have fee structures that are more expensive for smaller levels of investment. Agreement between funds could see greater sums invested in the lower cost fee range which would be beneficial to the funds.  Infrastructure investment may be possible through a collaborative approach that would not have been possible for individual funds as infrastructure investments tend to be for significant sums.  The investment performance is just as important or possibly more so as the investment return after costs is the real measure of investment success.  A small number of comprehensive framework procurement agreements for fund managers and professional advisers might be a good start.   * What would be the positive impacts?   The positive impact would be reduced costs through having larger sums at lower fee levels.   * What would be the negative impacts?   The drafting of agreements between funds could be time consuming and expensive while there could be significant transaction costs involved with getting a strategy in place.   1. Governance:  * What impact do you think promoting agreements between funds would have on governance?   Fund governance at a local a level would potentially be diminished as a result of funds reaching agreement on investment.   * What would be the positive impacts?   Through a sharing of best practice and knowledge there may be opportunities to improve scheme governance.   * What would be the negative impacts?   Provided the investment decisions reached will fully meet the objectives of each fund there should not be any significant negative impacts. Consideration would need to be given to the levels of delegation, representation of individual funds interests and flows of information across the participating funds which would require to be set out in appropriate legal agreements.  Agreements require to be documented and maintained – once they lapse they are an easy target for auditors to criticise and are therefore a governance risk.   1. Operating risks:  * What impact do you think promoting agreements between funds would have on operating risks?   In the context of a small pension fund with ~~very~~ limited resources there will be an increased workload to get agreements in place in the first instance but thereafter there should be improved resilience.   * What would be the positive impacts?   Improved resilience.   * What would be the negative impacts?   There may be an increased workload in establishing, monitoring and then maintaining agreements which will be time limited and subject to negotiation.   1. Infrastructure:  * What impact do you think promoting agreements between funds would have on funds’ ability to invest in infrastructure?   If the Scottish Government established a model agreement for funds to use for collaboration in infrastructure investment and had available suitable investment opportunities then promoting agreement between funds should lead to an increased ability to invest in infrastructure. Suggesting agreements are made on its own is unlikely to have much impact.   * What would be the positive impacts?   Increased diversification for pension funds and achievement of a political aspiration to see LGPS Funds investing in Scottish infrastructure projects.   * What would be the negative impacts?   It is possible that both the duration and returns from an infrastructure investment are not sufficiently attractive to merit the pension fund making an investment on purely financial grounds. Also, ~~but~~ if the investment opportunity is in a key project in the local area the decision makers judgement may be clouded by a desire to see the project delivered for reasons other than the investment return.   1. Do you have any additional comments about this option?   The merits of an initiative that appears to promote public sector infrastructure investment opportunities to private sector investors, while at the same time encouraging public sector pension schemes to go out and seek investment opportunities from across the private sector is questionable. |

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| Question 3: Pool investments between the 11 funds The text can wrap onto additional pages. |
| 1. Cost of investing:  * What impact do you think pooling investments between funds would have on the cost of investing?   It should be possible for larger pools to enjoy lower costs however it is not necessarily the case that bigger funds have lower investment costs: -    Source: Audit Scotland   * What would be the positive impacts?   Some direct investment opportunities may be possible that would not have been considered by the Fund due to the higher initial due diligence costs and/or scale of investment required.   * What would be the negative impacts?   The costs of restructuring would be significant and could be a drag on Fund performance for many years.  There would appear to be little justification for forcing through pooling of Funds when the funding levels are already good and fees levels are generally quite competitive.   * If asset pooling were possible, under what circumstances should a fund consider joining an asset pool?   If an asset pool is established that is invested in an asset class or classes that meet the Pension Fund’s investment strategy and the fee structure is better than is currently enjoyed then it may be worth joining the pool. This is essentially the same as any other investment decision made by the Fund.  Or, if the pool is able to offer an investment in an assets classes that the fund cannot access by another means.   * Under which circumstances should the SLGPS consider directing funds to pool?   If there is evidence that the funds are failing to achieve their objectives which can be attributed to poor investment returns and high fees and there is a firm belief that a pooling of investments will bring about an improvement in investment performance.   1. Governance:  * What impact do you think pooling investments between funds would have on governance?   There would be a further disconnect introduced between the investment decisions made by the pool and the fund leading to a reduction in accountability for investment performance. This will not be an improvement in governance but is arguably not that different from the position many admitted bodies are in currently.   * What would be the positive impacts?   It is hard to envisage any positive impacts on scheme governance through pooling of investments.   * What would be the negative impacts?   There is likely to be a significant diversion of resources required to establish the pools in the first instance which might be a detriment to governance.  With the funds being more remote there may be a reduction in good governance.   1. Operating risks:  * What impact do you think pooling investments between funds would have on operating risks?   For the Orkney Islands Council Pension Fund, it is unlikely that there would be any significant change. All investment decisions are currently delegated to Fund Managers who operate within investment guidelines. Pooled funds would operate in much the same way.   * What would be the positive impacts?   The operating risks may be slightly reduced through pooling if the due diligence on investment decisions is more extensive on account of the larger investments being made.   * What would be the negative impacts?   There is a lack of evidence to support pooling as a means to improve investment performance and the current and past performance of the Orkney Islands Council Pension Fund would suggest that the impact of pooling would be detrimental to investment returns.  LGPS pension funds – Net return on investment 2017/18 (unaudited figures)    Source: Audit Scotland   1. Infrastructure:  * What impact do you think pooling investments between funds would have on funds’ ability to invest in infrastructure?   Pooling of investments may make infrastructure investments more accessible to smaller funds but is unlikely to have much impact on the larger funds that already have infrastructure investments.  If the Scottish Government had available suitable infrastructure investment opportunities through a pooled vehicle in which the Scottish LGPS can invest then pooling of Pension Funds would not be necessary to achieve more infrastructure investment.   * What would be the positive impacts?   Achievement of a political objective.  Pooled funds with the critical mass to absorb very high startup costs for infrastructure investments.   * What would be the negative impacts?   The Government has an objective to secure more investment in infrastructure, however this may not fit with the Pension Scheme objectives.  There may be conflicts of interest between infrastructure investments and financial performance.   * Do you have any additional comments about this option? |

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| Question 4: Merge the funds into one or more new funds The text can wrap onto additional pages. |
| * Cost of investing: * What impact do you think mergers between funds would have on the cost of investing?   There may be savings on investment managers fees with larger portfolio sums but as for pooling there will be significant restructuring costs incurred along the way with no guarantee that improved investment performance will be achieved.  The critical measure of success would be investment performance net of fees.   * What would be the positive impacts?   Some direct investment opportunities may be possible that would not have been considered by the individual funds due to the higher initial due diligence costs or scale of investment required.   * What would be the negative impacts?   The costs of restructuring would be significant and could be drag on fund performance for many years.  There would appear to be little justification for forcing through mergers of funds when the funding levels are already good and fees levels are generally quite competitive.   * If merging were possible, under what circumstances should a fund consider a merger?   If it is mutually beneficial to the funds considering a merger.   * Under what circumstances should the SLGPS consider directing funds to merge?   If there is evidence that the funds are failing to achieve their objectives which can be attributed to poor investment returns and high fees and there is a firm belief that a merger of funds will bring about an improvement in performance.   * Governance: * What impact do you think mergers between funds would have on governance?   There would be a detrimental impact on governance as decisions would be completely removed from local control and accountability.   * What would be the positive impacts?   There would be less for the Pension Committees and Pensions Boards to concern themselves with as the investment activities would be the domain of the merged funds.  There may be improved resilience through having a larger organization.   * What would be the negative impacts?   A concentration of risks and reduction in diversification.  The merged fund would be accountable to more masters so may not truly be accountable to anyone.   * Operating risks: * What impact do you think mergers between funds would have on operating risks?   Merged funds may have more resources to effectively analyse risks and with larger structures could have in place better segregation of duties and invest in better research and risk management strategies.   * What would be the positive impacts?   Better management of risks.   * What would be the negative impacts?   A reduction in diversification and concentration of risks.   * Infrastructure: * What impact do you think mergers between funds would have on funds’ ability to invest in infrastructure?   Mergers between funds may make infrastructure investments more accessible to smaller funds but is unlikely to have much impact on the larger funds that already have infrastructure investments.  If the Scottish Government had available suitable infrastructure investment opportunities through a pooled vehicle in which the Scottish LGPS funds could invest then merger of Pension Funds would not be necessary to achieve more infrastructure investment.   * What would be the positive impacts?   Achievement of a political objective.  Merged funds with the critical mass to absorb very high startup costs for infrastructure investments.   * What would be the negative impacts?   The Government has an objective to secure more investment in infrastructure, however this may not fit with the Pension Scheme objectives.  There may be conflicts of interest between infrastructure investments and financial performance.   * Do you have any additional comments about this option?   The Orkney Islands Council, the administering authority for the Orkney Islands Council Pension Fund, also manages a portfolio of £215m of managed funds investments associated with the operation of an Oil Port under the Orkney County Council Act 1974. It is considered that the resilience of both Council members and officers to discharge their duties effectively would be adversely impacted if the Pension funds were to be merged into one or more funds. This could potentially see both the governance and performance of these non-pension fund investments deteriorate going forward, which would not be in the best interests of the people of Orkney. |

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| Question 5: Preferred and additional options The text can wrap onto additional pages. |
| 1. Which option does your organisation prefer? Please explain your preference.   Orkney Islands Council Pension Fund recognises that due to the small scale of its Fund that it has some vulnerabilities that may be removed in a larger organisation but it is highly sceptical that there would be any significant improvement in cost management or performance. From a position of relative strength our Fund is concerned that any change would be to our detriment~~al~~ and we would therefore prefer to retain the status quo of Option 1 to “Retain the current structure with 11 funds”.  If the Government were to develop an infrastructure investment vehicle that presented an attractive investment opportunity in which the Scottish LGPS funds could invest it should be possible to secure additional investment in infrastructure without incurring the very significant costs of pooling or mergers.  Our second choice would be Option 2 to “Promote cooperation in investing and administration between the 11 funds.”   1. What other options should be considered for the future structure of the LGPS?   With a scheme that is largely doing what it is intended to do at a reasonable cost there doesn’t really seem to be a compelling argument to fix something that isn’t broken.   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?   N/a   1. Are there any other comments you would like to make?   If a new scheme were being designed from scratch it is highly unlikely that the agreed design would be the current structure of 11 funds for 32 local authorities and many more admitted bodies with the smallest local authority also being one of the 11 administering authorities. |

The consultation questions end.