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.
Lothian Pension Fund, including: - Pensions Committee of the City of Edinburgh Council - Pension Board for the Lothian Pension Fund - Executive Team of Lothian Pension Fund.	Administering Authority, Pension Board and Fund officers

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.
Clare Scott, Chief Executive Officer of Lothian Pension Fund. Bruce Miller, Chief Investment Officer of Lothian Pension Fund	confirm

Date
Please date the response.

Date Draft 4/12/18 To be confirmed 12/12/18

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.

The City of Edinburgh Council is the administering authority for the Scottish Local Government Pension Scheme (SLGPS) in the Lothian area. The Council administers the benefits and invests the assets of three SLGPS funds, Lothian Pension Fund, Lothian Buses Pension Fund and Scottish Homes Pension Fund (Lothian).
Lothian Pension Fund is the second largest LGPS fund in Scotland with assets of £6.7 billion, 90 employers with active members and over 79,000 members. The Lothian Buses Pension Fund holds assets of £0.5 billion and 3,700 members, while Scottish Homes Pension Fund investments amount to £0.16 billion with 1,600 members.

Lothians maintains a comprehensive website for easy access to all relevant pension information and this is found at www.lpf.org.uk.

Investment governance is provided by a Joint Investment Strategy Panel (JISP), working in cooperation with the Falkirk Council and Fife Council Pension Funds. The JISP meets quarterly and includes senior officers and external investment advisers. The Pensions Committee of each pension fund agree their own investment strategy but delegate the implementation of strategy, including selection of investment managers, to officers. The JISP meets quarterly and includes senior Lothian officers and external investment advisers. It advises both pension fund administering authorities on implementation of investment strategy. The assets of Lothian Pension Fund, Falkirk Council Pension Fund and Fife Council Pension Fund remain separate.

Lothian's staffing resource is employed by an arms-length company, LPFE Limited (LPFE), which is wholly owned by the Council (in its capacity as administering authority for the Funds) and it is supervised by a board of directors chaired by the Council's Executive Director of Resources and includes the Convener of the Pensions Committee. LPFE facilitates bespoke new terms and conditions to enable Lothian to more effectively manage the risks and controls around its staff and enable it to pursue its collaborative initiatives for the benefit of stakeholders within an acceptable tolerance or risk.

The team carries out certain of its activities for the Funds through its Financial Conduct Authority authorised vehicle, LPFI Limited (LPFI). LPFI is also wholly owned by the Council (in its capacity as administering authority for the Funds). LPFI is supervised by a board of directors chaired by the Council's Head of Finance. An independent non-executive director sits on the boards of LPFI and LPFE. All the operations, costs and liabilities in relation to the Funds, including those of LPFE and LPFI, are borne by the Funds.

Lothian is unique in the SLGPS in having an internal investment team. The investment responsibilities include carrying out in-house investment management (currently approximately 68% of the Fund) and the monitoring and selection of external investment managers, as well as external facing collaborative initiatives with other like-minded pension funds. Other functions undertaken by Lothian's staff includes pension administration, employer liaison, data quality, customer support, accounting, legal, risk and compliance, communications and general business support.

Lothian is award winning. Lothian is regularly recognised through industry awards, it has held the customer Service Excellence award for over 13 years and is the only public sector entity to achieve accreditation in the Pensions Administration Standards Association.

The consultation questions follow.

CONSULTATION QUESTIONS

Question 1: Retain the current structure with 11 funds

The text can wrap onto additional pages.

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?*

Lothian is very well informed about investment costs. Lothian scrutinises investment costs as part of due diligence on investment opportunities, understands costs in the investment chain and aims to influence and structure fees in the best interests of the Fund.

Lothian has been an advocate for investment cost transparency for a number of years to the extent that its financial statements have disclosed all costs since 2015, contrary to CIPFA accounting guidance. Actual cost information is based on that provided by investment managers, with oversight from internal resource.

Lothian also participates in investment cost benchmarking, carried out by an independent third-party provider, and results are reported to Pensions Committee Here.

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

Summary –

- Cost reporting lacks transparency and consistency; current CIPFA standards promote the under-reporting of costs; under-reported SLGPS costs are estimated at approximately c£70-80m per annum.
- SLGPS is overly reliant on external managers, paying significant profits to external managers of £65m - £90m per annum.
- There is little evidence to support the notion that higher costs lead to higher net returns.
- In-house management is a cost-effective option, with the potential to save SLGPS c£70m per annum.

Cost reporting lacks transparency and consistency. Lack of transparency of investment costs is a national (UK) and industry-wide issue. Lothian has previously written to CIPFA Pensions Panel to highlight the lack of transparency in LGPS financial statements. The lack of transparency and inconsistency of reporting between funds makes evidencing and managing costs difficult across the SLGPS. Full investment costs of SLGPS are generally not disclosed in financial statements, particularly where there are layers of fees e.g. fund-of-fund arrangements. The lack of transparency of investment fees and general lack of comparability of other aspects of the SLGPS hinders policymakers.

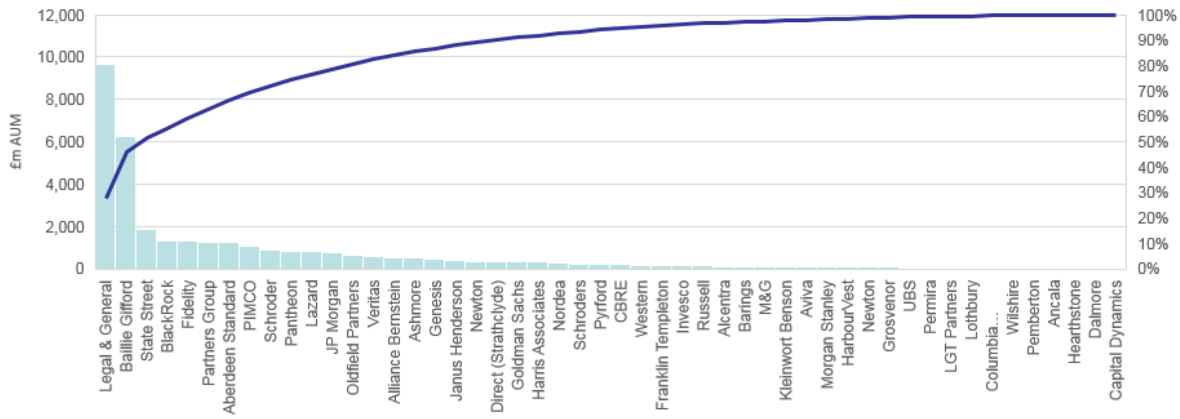
Current CIPFA standards under-report costs. The following table shows the significant difference in fees disclosed in financial statements for 2014/15 as a percentage of assets, when CIPFA guidance reversed disclosure, for the largest three SLGPS funds. It shows that the reversed disclosure significantly understates fees.

	Investment Fees for 2014/15 as % of Assets			
	Original (full) disclosure	Revised (partial) disclosure	Difference	Original vs Revised disclosure
Strathclyde Pension Fund	0.80%	0.57%	0.23%	+40%
Lothian Pension Fund	0.50%	0.50%	-	-
North East Pension Fund	0.57%	0.42%	0.15%	+36%

Under-reported SLGPS costs are c£70m - £80m per annum. For 2017/18, SLGPS investment fees (representing 90%+ of total management fees) shown in financial statements were £207.8million (approximately 0.47% of investments). As the above table illustrates, this is significantly under-reported due to CIPFA guidance. If the under-reporting is consistent with 2014/15, fees of c£200m could be under-reported by 35%-40% per year, equivalent to between £70m - £80million per year.

SLGPS overly reliant on external managers. The chart below shows the total SLGPS assets managed by external investment managers as at 31 March 2018 (left hand axis) and the cumulative proportion (right hand axis). The graph shows:

- two managers (Legal & General and Baillie Gifford) manage approximately half of SLGPS assets managed externally;
- ten managers manage approximately 70% of the externally managed SLGPS assets;
- there are over 52 external investment managers named in the funds' financial statements. This is a significant underestimate due a number of managers being manager-of-managers (e.g. Partners group, Schroder, Strathclyde Direct, Capital Dynamics).

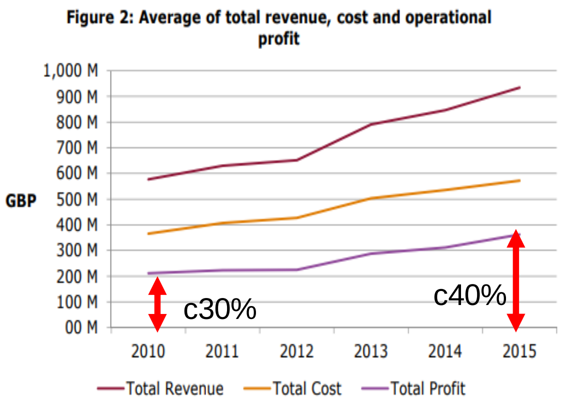


SLGPS is paying significant profits to external asset managers. Asset management is a highly profitable industry. This is evident in the FCA's 2017 *Asset Management Market Study* which found that there was:

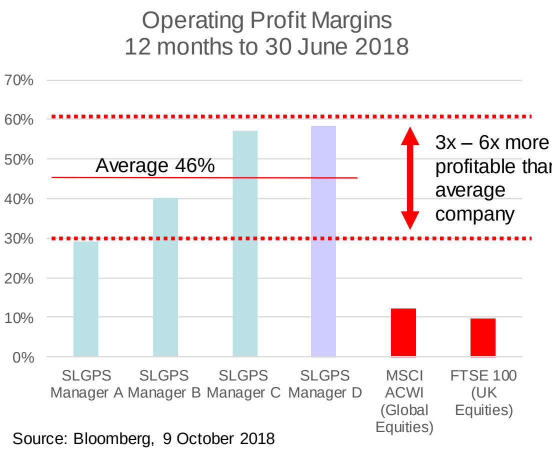
- weak price competition

- lack of alignment between performance and costs
- a lack of cost awareness amongst some investors.

The FCA study showed asset managers achieving average operating profit margins of 30% - 40% from 2010-2015. Our own analysis of profit margins for four listed asset managers (within the top 10 SLGPS external managers) at 30 June 2018, showed average profit margins of c46%. Asset manager profit margins are between three to six times more profitable than the average company supporting the FCA's finding that there is weak price competition in the industry (refer to charts below).



Source: FCA Asset Management Market Study Interim Report (Nov 2016) - Annex 8, pg 9



Source: Bloomberg, 9 October 2018

The majority of the c£208m in SLGPS investment costs is paid to external asset managers. Assuming an average profit margin of between 30% - 45%, the SLGPS is paying out £60m to £95m in profits to the asset management industry on an annual basis.

In-house management is a cost-effective option. Lothian is the only fund within SLGPS that manages investments internally. At 31 March 2018, the team managed c68% of LPF's assets on a direct basis, with an in-house investment expense ratio of 0.09%. The ratio of 0.09% is 80% lower than the ex-Lothian SLGPS investment expense ratio of 0.47%. The annual savings from applying the in-house ratio to ex-Lothian SLGPS assets would be c£70m pa. This figure is within the range of the estimated £65m - £90m being paid out in external manager profits, noted above.

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

Compulsory reporting and benchmarking. Work by the FCA's Institutional Disclosure Working Group, with the backing of the English & Welsh LGPS Scheme Advisory Board, and the introduction of standard templates for cost disclosure should improve cost transparency. The SLGPS Scheme Advisory Board should also compel funds to obtain and disclose this information and to participate in cost benchmarking.

Review of reporting standards to disclose full costs. CIPFA reporting standards should also be amended to ensure disclosure of full costs in funds' financial statements and investment performance, both net and gross of fees.

Greater insight on costs should provide greater insight for decision making and/or lead to better cost management.

Funds should be resourced accordingly to undertake such granular analysis of costs (see comments below on resource).

b) Governance:

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

Lothian is fully informed about its governance through its knowledge of its operations, and regulatory requirements. Details are included on our website and reported in our annual report. Governance issues, including compliance with attendance and training policies, are regularly reported to Pensions Committee and Pension Board.

- *How well is the current system governed?*

The governance of the current system has significant weaknesses. Whilst each fund is subject to scrutiny through its own governance and audit, there is a lack of consistency in the available information that makes it difficult for stakeholders and the Scheme Advisory Board to judge the effectiveness of the Scheme as a whole. Comparable data from individual funds is also deficient, particularly in relation to investment costs (as shown above). This lack of clarity has hindered previous reviews of the SLGPS structure and remains a very relevant factor today.

Lothian has developed its governance to reflect best practice within the constraints of the current regulatory structure, including:

- Representation of non-administering authority employers and members on the Pensions Committee
- Employment of an Independent Professional Observer to provide support to Committee and Board
- Delegation of investment strategy implementation to the Head of Finance taking advice from a professional Investment Strategy Panel of internal and external independent advisers
- Delegated “Section 95” finance officer responsibility to reinforce the statutory ring-fencing of the pension funds from the Administering Authority and avoid conflicts of interest
- Internal investment team, with appropriate risk controls and oversight, which brings greater alignment of interest and reduced costs. This has enabled significant investment in infrastructure.
- Separate employment of resource to bring enhanced controls and, critically, the ability to respond to specific market conditions to recruit and retain resource.

However,

- Governance of the SLGPS is also inefficient. In the region of 150-180 people are involved in the Pensions Committee and Pension Boards, many with limited knowledge and experience of pension matters

- Councils acting as Administering Authority bring governance issues. Local Government regulations restrict representation and nevertheless, the majority of SLGPS Pension Fund Committees comprise solely of councillors from the Administering Authority (Local Government Act 1973). Councilors do not necessarily have knowledge and expertise in pensions. The inevitable turnover in membership of the Pensions Committees makes it difficult to develop the necessary understanding in such a complex area as pensions. Both officers and elected members have conflicts of interest, for example, with councilors and officers being responsible for setting employer contribution rates for the pension fund as well as managing council's finances. Conflicts can also arise in decisions regarding local investments
- Members of the Pension Board take on this role voluntarily, do the work alongside their other work/union duties and usually have little or no pensions expertise. Lothian's Pension Board has experienced frequent turnover in and has had vacancies on a regular basis
- Lothian has, for many years, invited and welcomed the involvement of members and employers in the governance of the Fund, through its Consultative Panel prior to the introduction of the Pension Board. Regulations confuse the scrutiny role (which the Pension Board is required to undertake by the Public Sector Pensions Act on behalf of the Pensions Regulator) and the Committee's mechanism of consulting with employers and members in day-to-day governance. Lothian believes the two roles should be more distinct.
- There are significant key person risks and funds generally lack internal resource. As a result, funds are heavily and unduly reliant on external suppliers, particularly for investment services (see above)
- There is significant duplication of effort across the SLGPS across all areas of the pension fund and an inability to capture economies of scale.
- Some employers have members in more than one SLGPS fund (for example, Police Scotland, Scottish Fire and Rescue, Scottish Water, Visit Scotland). As well as dealing with different practices in data transfer, these employers experience different funding strategies from different funds. The employees of these organisations can also experience different administration practices which can cause frustration
- Differences in funding have also been highlighted by advisers to third-sector employers participating in the LGPS in their dealing with cessations/exits from funds.

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

Summary

- A bespoke governance structure, distinct from the current administering authority model.
- Mandatory member and employer representation on Pensions Committees
- Pension Board should focus on scrutiny role
- Committees and Boards should have greater expertise

- Pension funds should have a Section 95 officer separate from the Administering Authority
- Recommendations of Scottish Government's 2016 review of governance arrangements should be implemented
- Multi-fund employers should be encouraged to consolidate members into one fund

A bespoke governance structure, distinct from the current administering authority model, would facilitate better management of conflicts of interest and facilitate wider involvement of stakeholders (including members of the fund, representatives from councils and other employers which are not currently administering authorities).

If the current administering authorities are retained, there should be mandatory member and employer representation on of Pensions Committees.

There should be a Section 95 officer for the pension funds, distinct from that for the Administering Authority. The pension fund should have a distinct budget and resource, (to avoid Council's financial constraints being inappropriately being applied to the pension fund) with agreements in place for any costs/services paid to/received from the council. (It should be noted that the English & Welsh LGPS are currently reviewing the potential separation of the pension fund from the administering authority and lessons could be drawn from that review).

Regulations confuse the scrutiny role of the Pension Board and the mechanism of funds consulting with employers and members in its governance. Lothian believes the two roles should be more distinct. If employers and members had representation in the fund's governance, the Pension Board could focus purely on its scrutiny role.

Committees and Boards would benefit from membership with greater expertise.

Recommendations of Scottish Government's review of governance arrangements (undertaken in 2016 by KPMG), should be implemented, particularly around clarifying roles and responsibilities and training for both the Scheme Advisory Board and Pension Boards.

For employers who have members in more than one SLGPS, options to consolidate membership into one fund should be promoted.

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

Democratic accountability is important as the majority of members of the SLGPS are council staff and, ultimately, costs are paid by council taxpayers. However, only 11 out of the 32 Scottish councils are administering authorities – the majority do not have governance rights within the current structure.

Given the inherent weaknesses of the funds' governance (noted above) Lothian believes that the governance of the SLGPS should be distinct from councils. A bespoke governance model should be developed which retains democratic accountability but brings greater wider involvement of stakeholders (including members of the Fund and representatives from councils and other employers which are not currently administering authorities).

a) 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. This does not prevent SLGPS to benefit from greater scale.

c) 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?*

A summary of the Fund's risks is reported to the Pensions Committee every quarter. The Pensions Audit Sub-Committee also reviews the Fund's full risk register annually. These reports are also considered by the Pension Board.

The risks are an assessment by the Fund's management team.

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

Lothian has a strong risk management culture. Internal resource includes a dedicated Chief Risk Officer and a dedicated Chief Finance Officer with Section 95 responsibility for the Fund.

Lothian has made a number of structural changes to better manage risk in recent years (see above regarding the Fund's governance), notably the transfer of employment of officers from the council to a company which is wholly owned and financed by the Council, as administering authority of the pension fund. This is unique in the SLGPS.

Assurance is obtained from internal and external auditors as well as external advisers, including independent professional observer, independent investment advisers and non-Executive Director on the board of the pension fund companies.

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

Establishing a framework of standards expected of the SLGPS would set out expectations against which funds' performance can be measured.

Simplification of the SLGPS benefits would greatly reduce the administrative and operating risks and costs.

As recommended by the review undertaken by KPMG, improved governance relating to the Scheme Advisory Board and Pension Boards, including clarity of roles and responsibilities and training requirements for its members, would help to scrutiny of the SLGPS and focus on the appropriate issues and risks.

d) Infrastructure:

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

Lothian's internal investment team have built up experience of infrastructure over the past 12 years. Infrastructure exposure is detailed in its financial statements and annual report. Lothian Pension Fund has a high allocation to infrastructure (£745million, 11.4% at 31 March 2018) and has one of the most diverse portfolios in the LGPS in the UK. It has performed well, delivering 12.5% per annum since inception.

Exposure is obtained via primary and secondary funds, co-investments and specified asset funds. Market intelligence, including insight from a wide range of external investment managers, informs the fund's strategy. Lothian's internal legal team provides execution capabilities.

Lothian's Investment Strategy Panel, including external advisers, oversees the Fund's strategy.

- *How do you rate the current system's ability to invest in infrastructure?*

Lothian's infrastructure exposure has been made possible due to the Fund's in-house investment expertise and the governance arrangements which facilitate nimble decision making. Most other SLGPS funds who invest in infrastructure rely on fund-of-funds managers where the deployment of capital can be slow, costs are significantly higher and tailoring the investment strategy difficult.

Lothian's FCA authorisation has facilitated Falkirk Council Pension Fund and Borders Pension Fund to access Lothian's due diligence on infrastructure (and other) investments (see below).

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

Those administering the LGPS funds have a fiduciary duty to their members and employers and therefore the Scottish Ministers should not compel the SLGPS funds to make any such investment. LGPS assets should not be used to satisfy a political appetite for economic regeneration. The governance relating to infrastructure investments should avoid conflicts of interest, particularly in relation to 'local' investments.

With increasingly mature liabilities and a trend of reducing investment risk, many funds are increasingly looking for lower-risk investments. Infrastructure investments with long-term, secure inflation-linked income could therefore prove to be attractive. Funds are generally not looking to invest in speculative developments. Guarantees provided by institutions with secure financial backing could enhance the attractiveness of investments.

Lothian, through its FCA authorised company LPFI Limited, is able to provide advice to other funds and share its due diligence on investments. This has helped Falkirk and Scottish Borders Pension Funds to increase their investment in infrastructure (see next section on cooperation).

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

Despite being relatively well funded, the SLGPS faces significant challenges under the current structure.

Employer contributions required to meet the costs of the Scheme have risen significantly in recent years, despite the introduction of the career average scheme in 2015. Indications from the English & Welsh cost cap calculations are that there is likely to be additional upward pressure on employer contributions from 2020.

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

The text can wrap onto additional pages.

a) Cost of investing:

- *What impact do you think promoting agreements between funds would have on investment costs?*

As noted above, there is a lack of transparency of investment fees for the individual funds and the SLGPS as a whole. Such transparency should improve decision making of the individual funds and compulsory reporting by funds, with appropriate oversight, should improve governance of the overall SLGPS in the future.

However, given the commonality of investment strategies cooperation could deliver significant savings, when comparing with the true underlying costs which are currently being paid. Potential cost savings, and the sustainability of such savings, critically depends on governance.

Cost savings could be achieved with external investment management, particularly in asset classes which are typically more expensive e.g. private markets and particularly where funds invest in 'fund-of-funds' arrangements. Funds are increasing investing in these more expensive areas.

Further, Lothian's internal investment arrangements have delivered, and continue to deliver, significant savings of investment costs and, subject to governance, this resource could be utilised by other funds.

- *What would be the positive impacts?*

The impacts will critically depend on the governance arrangements of the cooperation. For example, the greater the consistency in the way in which investment strategy is defined and implemented, the greater the potential fee savings. Currently, these decisions are all made by different funds and are influenced by different advisers.

The greatest savings could come from reducing external investment manager fees, particularly in more expensive asset classes and current fund-of-funds arrangements.

Further savings could be made with internal resource from funds being utilised by others, facilitating in-sourcing of investment management functions. This could also bring wider governance benefits (see below).

- *What would be the negative impacts?*

Lothian has concerns over the potential governance of greater cooperation and the ability for collaboration to achieve scale.

Our experience of cooperation with other funds is that for this to work effectively, there needs to be similarity in the governance arrangements of the funds (e.g. delegation to officers to enable swift decision-making to take place).

Without suitable alignment, willingness and resource, decision making ability could be adversely affected and arrangements may be inefficient and unsustainable.

b) Governance:

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

Governance of the arrangements are critical in any cooperation. There needs to be clear lines of responsibility and accountability as well as appropriate scrutiny.

Lessons could be drawn from our experience of cooperation with Falkirk and Fife Pension Funds:

- Development of relationships and trust has been a foundation of the cooperation.
- The cooperation has evolved over the last 6 years.
- The delegation of investment strategy implementation and selection of investment managers was the most fundamental change to Falkirk and Fife's governance to facilitate greater cooperation. This is uncommon in the SLGPS.
- The Joint Investment Strategy Panel is in its very early stages and its success in terms of delivering cost savings has not yet been proven.
- Pensions Committees and officers retain decision making for their respective fund based on advice from LPFI. Therefore each fund needs to continue to retain sufficient resource with knowledge and experience to make such decisions and to maintain 'professional investor' status.

- *What would be the positive impacts?*

There could be opportunities for funds to share resources, reduce risk, deliver efficiencies and improve services.

- *What would be the negative impacts?*

As decision making would be retained by funds, there can be uncertainty of whether the cooperation will produce results.

Without clear governance arrangements, cooperation could:

- make decision making more complicated and slower;
- introduce additional layers of governance;
- be hindered by the lack of resource in some funds;
- lack sustainability.

Lothian's FCA authorisation means that it is exposed to additional regulatory risks.

c) Operating risks:

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

The risks will depend on the governance of the cooperation. As noted above, additional risks may result.

- *What would be the positive impacts?*

Cooperation could reduce key-person risks faced by funds, particularly the smaller funds, and hence help to develop more sustainable resources.

- *What would be the negative impacts?*

Cooperation could bring additional operational risks (as noted above):

- make decision making more complicated and slower;
- introduce additional layers of governance;
- be hindered by the lack of resource in some funds;
- lack sustainability.

d) Infrastructure:

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

The cooperation between Lothian and other LGPS funds (Falkirk, Fife, Scottish Borders and Northern Ireland) has enabled investing in greater scale and for other funds to benefit from the commercial advantage of Lothian's in-house team. This element of the cooperation with Falkirk Council Pension Fund has been in place for approximately 3 years and has facilitated investment of £100million into around 20 different investment vehicles.

The cooperation gives all Funds involved greater scale and access to opportunities that are unlikely to have been available otherwise.

- *What would be the positive impacts?*

Greater flexibility for funds to implement investment in infrastructure for those funds who choose to invest in this asset class.

- *What would be the negative impacts?*

Such cooperation initiatives could put undue pressure on funds to invest in infrastructure. This is not necessarily in the best interests of members and employers. The governance relating to infrastructure investments should avoid conflicts of interest, particularly in relation to 'local' investments.

As above, without clear governance arrangements, cooperation could:

- make decision making more complicated and slower;
- introduce additional layers of governance;
- be hindered by the lack of resource in some funds;
- lack sustainability.

As above, Lothian's FCA authorisation means that it is exposed to additional regulatory risks.

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

Our experience of collaborating with other funds shows that such arrangements can take time to establish and require governance changes. The current Joint Investment Strategy Panel is in very early stages and its success in terms of delivering cost savings has not yet been proven. Further, the Joint Investment Strategy Panel arrangement is not scalable.

Overall, Lothian has concerns that relying solely on greater cooperation could be sub-optimal, could adversely impact on the Fund and avoid more integrated change which is necessary to achieve optimal efficiencies.

Question 3: Pool investments between the 11 funds

The text can wrap onto additional pages.

a) Cost of investing:

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

As noted above, there is a lack of transparency of investment fees for the individual funds and the SLGPS as a whole.

Lothian believes that, with the commonality of investment strategies, and our awareness of fees in the industry, combining investments would undoubtedly deliver significant savings in investment fees.

In-house management is the clearest and most effective way for SLGPS to reduce the cost of investing. Cost savings could also be achieved from consolidation of external investment management arrangements and reduced reliance on expensive investment vehicles.

In comparison with the Universities Superannuation Scheme (USS) (£63 billion, 418,000 members, 380 employers and an in-house investment team), the SLGPS is significantly more expensive. USS investment fees are 34% lower (0.31% of investments, compared to 0.47% for the SLGPS), largely attributable to the fact that c75% of USS assets are managed internally (vs c10% for SLGPS). While we note that the USS expense ratio of 0.31% is based on independent third-party benchmarking analysis, not their accounts, we also believe it to be more rigorous than the SLGPS ratio of 0.47% given the under-reporting of SLGPS fees (as described earlier).

If SLGPS could achieve the USS expense ratio of 0.31%, fee savings could be £65million per annum, and given the under-reporting of SLGPS fees, actual savings could be materially higher. More expensive investments are typically illiquid so savings from these allocations could take time to materialise. However, separate analysis (based on Lothian's internal team expense ratio of 0.09%) suggests that material savings of £65m per annum would be possible from in-house management of SLGPS liquid assets alone.

While evidence from England and Wales pooling suggests that set-up costs have been significant, cost savings could outweigh these but savings may take time to materialise. The compounding effect of cost savings and the incremental returns on costs saved, should significantly outweigh any initial setup costs.

- *What would be the positive impacts?*

Pooling provides an opportunity for the SLGPS funds to achieve a greater level of assets being managed in-house, resulting in reduced investment cost. The clearest path to this would be through leveraging Lothian's internal investment team which has an investment expense ratio that is 80% lower than the overall SLGPS. Cost savings would be offset by initial set-up costs, but once achieved, the cumulative savings over the long term would be substantial (e.g. on a cumulative basis £1bn by year 10, £3.bn by year 20, £8bn by year 30).

- *What would be the negative impacts?*

Set up costs could be significant.

Fees savings would only be optimised if pooling is compulsory. If individual funds retained the option whether or not to pool investments or not on an asset-by-asset basis, fee savings may not be delivered.

There would be additional layer of governance and associated costs. Individual funds would need to retain resource and expertise to set strategy and to oversee pool(s).

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

Funds need to consider what is in the best interests of their members and employers in considering whether to join an asset pool. Considerations should include:

- Governance of pooling versus not pooling including resourcing and alignment of interest;
- Investment options offered by the pool and associated costs;
- Track record;
- Operational risks.

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

Given our reservations on pooling, we do not think there are circumstance where funds should be directed to pool.

b) Governance:

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

Pooling would have a significant impact on governance. It has the potential to improve investment decision making by allocating greater and specialised resource, including internal resource. However, pooling adds an additional layer of governance between the funds and the investment manager.

Careful consideration would need to be given to the most appropriate legal structure(s). In England and Wales, structures and governance vary significantly between the pools and lessons should be drawn from their experience.

- *What would be the positive impacts?*

Pooling could bring the greater professionalism into the investment governance of the SLGPS, including internal investment management resource.

- *What would be the negative impacts?*

As above, pooling adds an additional layer of governance between the fund and the investment manager.

There is no clear distinction between strategic investment decisions and investment implementation as evidenced by pools in England and Wales adopting different approaches. There would be difficulty in funds agreeing an approach for a SLGPS pool. Funds may consider the investment options offered by the pool as too restrictive and, and as a result, asset pooling, and cost savings, would not be optimised.

There could also be a lack of clarity of responsibility for responsible investment and stewardship matters i.e. who votes and engages on shareholdings?

c) Operating risks:

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

  Having sufficient qualified and experienced resource at the pool should lead to better manager selection. This should reduce key person risk at the Funds.

- *What would be the positive impacts?*

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

  Funds could devote more time to non-investment operational risks.

- *What would be the negative impacts?*

Funds' resource could be transferred to the pool, therefore exacerbating their operational risks.

The time spent in England and Wales to establish the pools has been significant and this could increase operational risks for the SLGPS.

d) Infrastructure:

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

Pooling should enable more funds to invest in infrastructure. While Lothian itself has an established infrastructure programme, pooling could give access to wider infrastructure opportunities, with more favorable terms.

- *What would be the positive impacts?*

Opportunities, particularly for smaller funds, to increase exposure to the asset class.

- *What would be the negative impacts?*

There is a potential risk that enforcement of initiatives, such as investing in infrastructure, endangers the funds' fiduciary duty to act in the best interests of the members and employers. It needs to be recognised that political desire for infrastructure is not necessarily in the best interests of members and employers. Conflicts of interest need to be avoided, particularly for local investments.

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

Pooling is untested, clouds governance responsibilities and creates a new tier of bureaucracy. It would be disruptive and could adversely impact Fund members and employers.

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

The text can wrap onto additional pages.

a) Cost of investing:

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

Merger would undoubtedly deliver significant savings in investment fees.

In-house management is the clearest and most effective way for SLGPS to reduce the cost of investing. Cost savings could also be achieved from consolidation of external investment management arrangements and reduced reliance on expensive investment vehicles. In-house management is best practice for large funds with sufficient scale and governance to implement (e.g. Lothian) and the clearest route to generating cost savings for SLGPS. This is evidenced worldwide, where large funds manage more of their assets in-house –

- In Canada, the top 10 largest funds manage an average of 80% of assets in-house. PwC's Global Pension Funds best practices report states "… the practice is considered a key factor in cost savings for Canadian pension funds and is credited as a main reason for their success."

- In the US, funds with US$50bn+ manage an average of 45% assets in-house; CalPERS - the largest US state fund – manages 75% assets in-house;

- The UK's largest fund, USS, manages 75% assets in-house;

- Sweden's largest fund, Alecta, manages close to 100% assets in-house;
-
- Australia's largest fund, AustralianSuper, plans to increase its in-house assets from 23% to 50% over the next few years. Other Australian funds have also been in-sourcing asset management as they become large enough to hire professional investors, thereby saving on fees that would be paid externally.

Fund merger, alongside appropriately revised governance structures, provides the most direct route to increased in-house management and significant cost savings for SLGPS.

In comparison with the Universities Superannuation Scheme (USS) (£63 billion, 418,000 members, 380 employers and an in-house investment team), the SLGPS is significantly more expensive. USS investment fees are 34% lower (0.31% of investments, compared to 0.47% for the SLGPS), largely attributable to the fact that c75% of USS assets are managed internally (vs c10% for SLGPS). While we note that the USS expense ratio of 0.31% is based on independent third-party benchmarking analysis, not their accounts, we also believe it to be more rigorous than the SLGPS ratio of 0.47% given the under-reporting of SLGPS fees (as described earlier).

If SLGPS could achieve the USS expense ratio of 0.31%, fee savings could be £65million per annum, and given the under-reporting of SLGPS fees, actual savings could be materially higher. More expensive investments are typically illiquid so savings from these allocations could take time to materialise. However, separate analysis (based on Lothian's internal team expense ratio of 0.09%) suggests that material savings of £65m per annum would be possible from in-house management of SLGPS liquid assets alone.

- *What would be the positive impacts?*

As noted above, and in question 3, investment is a scale business so costs would be lower.

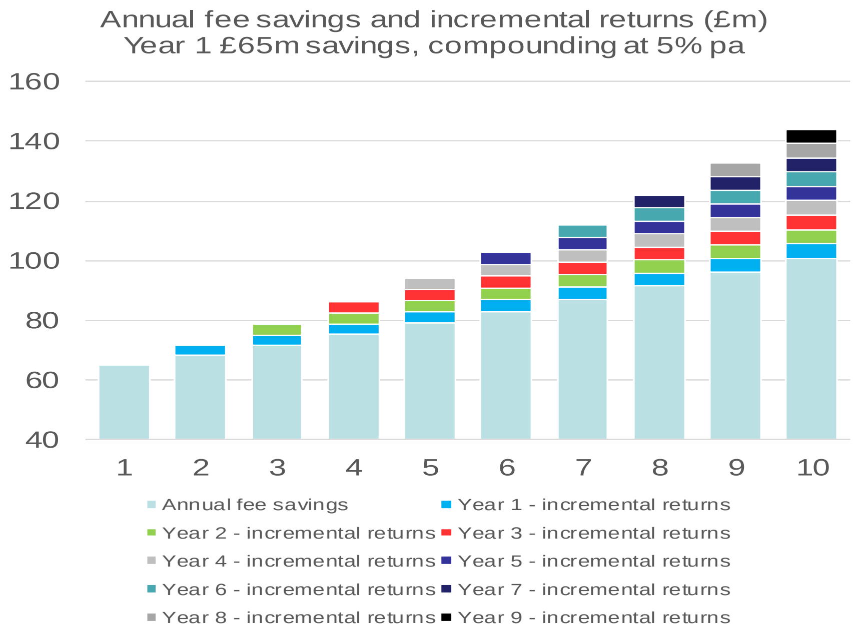
There would be an increased set of investment opportunities and greater influence over the terms of investment.

Better control of costs through an enlarged structure being able to devote greater resource to this complex area. Better investment governance through the larger fund being able to attract specialist expertise.

Merger(s) should also reduce pensions administration costs. However, and perhaps more importantly, it would facilitate improved service and better operational risk management including key person risks, at a time when the Scheme is facing increased scrutiny from The Pensions Regulator and other stakeholders. All the funds use the same pensions administration system which should facilitate merger.

However, the most significant impact in terms of cost savings will arise from a greater proportion of assets being managed in-house. Further, the benefits from initial savings will compound over time.

For example, £65m in fee savings from in-house management provides a benefit in "Year 1" when it is realised, but it is also a benefit in year 2, where it would have also been paid, and every year after. Further, the £65m saved in year 1, generates incremental returns in year 2, year 3, year 4 etc into the future. The example of fee savings and incremental returns, year on year, is shown in the chart below.



The chart shows that £65m in savings in "Year 1", becomes c£100m of savings in year 10 (as underlying assets have grown). Further additional benefits from incremental returns come to £40m in year 10. Cumulatively, by Year 10, SLGPS has benefited by £1bn in total (from initial savings of £65m in Year 1). The long-term benefit from in-house fee savings will therefore far outweigh any initial transaction/merger costs.

- *What would be the negative impacts?*

The establishment of a merged entity may need mutual agreement between various parties and this could take some time to establish. The costs however, should be relatively small in relation to the potential cost savings.

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

Lothian would consider merging if it was accompanied by:

- An effective, resourced governance structure with engaged employers and members, with wider involvement of stakeholders (including representatives from councils and other employers which are not currently administering authorities). This would be <u>distinct from the current administering authority model</u>
- Best practices for all funds, including scale facilitation of in-house investment and full fee transparency
- Delegation of implementation of investment strategy in a manner similar to that used by LPF to capture the 'governance premium'
- The funding positions of individual employers are protected (i.e. there are no cross subsidies)
- Service delivery to members and employers retains a 'local' connection.

The long-term sustainable benefits more than outweigh limited initial outlays. Benefits include:

- Clear governance to reinforce SLGPS duties to members and employers and minimise conflicts of interest
- Economies of scale on investments and otherwise, with reduced duplication and fewer advisers
- Consistency of service (e.g. funding, data, administration) particularly for the benefit of employers in multiple funds
- Less governance resource across the SLGPS as a whole
- Opportunity to resource adequately and better control operational risks
- Potential to involve professional skills to enhance governance and decision making.

Therefore, Lothian's preferred option would be to work with like-minded partners on a voluntary basis to develop a mutually beneficial merger solution.

- *Under what circumstances should the SLGPS consider directing funds to merge?*

Directing funds to merge would be appropriate if merging funds is shown deliver the best outcome for members and employers.

Lothian’s preference is to develop a governance structure with like-minded fund(s) (as above).

There needs to be appropriate periodic scrutiny of the structure of SLGPS to assess the effectiveness of any changes resulting from this review, and ensure lessons are learned. We have concerns that without such oversight, lessons will not be learned, inefficiencies will continue which could leading to further SLGPS structure reviews in the future. The Pension Board of Lothian Pension Fund feel that given the radical changes that will be needed in order to allow such mergers to take place within a reasonable time period, that it would be prudent and necessary for the Scottish Government specify the number of merged funds and expected timescales for funds to work together to deliver an effective model in order to make such merged funds into a viable reality.

b) Governance:

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

There would be significant impact on governance.

Merger provides an opportunity to address the inherent weaknesses in the SLGPS’s current governance, as outlined in question 1b above.

- *What would be the positive impacts?*

Benefits include:

- Effective, resourced governance structure with engaged employers and members, with wider involvement of stakeholders (including representatives from councils and other employers which are not currently administering authorities). This would be distinct from the current administering authority model to reinforce SLGPS duties to members and employers as distinct from council responsibilities
- Less governance resource across the SLGPS as a whole
- Less reliance on advisers
- Consistency of service (e.g. funding, data, administration) particularly for the benefit of employers in multiple funds
- Potential to involve professional skills to enhance governance and decision making.

- *What would be the negative impacts?*

Merger may increase the risk of central government interference and/or the risk that the fund may not be accountable to the stakeholders. Appropriate governance would need to be put in place to guard against these risks.

c) Operating risks:

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

With clear governance and appropriate resourcing and management, merger(s) should reduce operating risks.

However, change brings uncertainty for the people involved in administering the funds and there are likely to be greater short-term operational risks while the merger is implemented. This would need to be managed.

- *What would be the positive impacts?*

Improved governance and resourcing should improve risk awareness and management.

- *What would be the negative impacts?*

Uncertainty over the future structure for the SLGPS and the perception of an adverse impact on staff, increases operational risks. We would suggest that decisions are made and changes implemented as quickly as possible, with appropriate engagement and communication, in order to minimise operational risks and any impact on services.

d) Infrastructure:

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

Merged, larger funds could access to wider investment opportunities, and with appropriate resourcing, there should be a greater ability to invest in infrastructure.

- *What would be the positive impacts?*

As noted above, larger funds could access greater investment opportunities, and with appropriate resourcing, there should be an enhanced ability to invest in infrastructure.

There would be greater negotiating power on fees and other governance rights.

Merger(s) would also bring consistency in a number of different areas including funding, actuarial valuations and pensions administration, including member service and communications. This would be helpful for employers which have members in more than one fund.

- *What would be the negative impacts?*

As noted above, there is a potential risk that enforcement of initiatives, such as investing in infrastructure, endangers the funds' fiduciary duty to act in the best interests of the members and employers. It needs to be recognised that political desire for infrastructure investment is not necessarily in the best interests of members and employers. Governance of merged fund(s) needs to enforce this and should avoid conflicts of interest, particularly in relation to 'local' investments.

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

Merger into one fund could make the governance too remote from stakeholders and also bring greater risk of government interference.

As highlighted earlier in the paper, our experience of collaborating with other funds shows that working with like-minded funds on a voluntary basis to merge funds is more likely to be successful.

Question 5: Preferred and additional options

The text can wrap onto additional pages.

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

Lothian's preferred option would be to work with like-minded partners on a voluntary basis to develop a mutually beneficial merger solution which has:

- An effective, resourced governance structure with engaged employers and members, with wider involvement of stakeholders (including representatives from councils and other employers which are not currently administering authorities). This would be distinct from the current administering authority model.
- Best practices for all funds, including scale facilitation of in-house investment and full fee transparency;
- Delegation of implementation of investment strategy in a manner similar to that used by LPF to capture the 'governance premium'
- The funding positions of individual employers are protected (i.e. there are no cross subsidies)
- Service delivery to members and employers retains a 'local' connection.

Long-term sustainable benefits, more than outweighing limited initial outlays, should include:

- Clear governance to reinforce SLGPS duties to members and employers and minimise conflicts of interest
- Economies of scale on investments and otherwise, with reduced duplication and fewer advisers including the potential for increased in-house management, generating significant savings
- Consistency of service (e.g. funding, data, administration) particularly for the benefit of employers in multiple funds
- Less governance resource across the SLGPS as a whole
- Opportunity to resource adequately and better control operational risks
- Potential to involve professional skills to enhance governance and decision making.

Lothian acknowledges that merger may not be palatable to some stakeholders - some highlight their concerns about central government interference - and merger to a single fund would be a complex project requiring a positive commitment by all Funds.

Therefore, Lothian's preferred option for its stakeholders would be to work with like-minded partners on a voluntary basis to develop a mutually beneficial merger solution.

For the SLGPS as a whole, Lothian believes a 2 or 3 merged fund approach, with governance improvements as above, would be the most appropriate solution.

The Pension Board of Lothian Pension Fund feel that given the radical changes that will be needed in order to allow such mergers to take place within a reasonable time period, that it would be prudent and necessary for the Scottish Government to provide directive instruction on the number of merged funds and expected timeliness for funds to work together to deliver an effective model in order to make such merged funds into a viable reality.

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

The lack of consistency of reporting (including investment fees) of funds hinders policymakers overseeing the Scheme. Such transparency should also improve decision making of the individual funds. Consideration should be given to compulsory reporting, with appropriate oversight, to improve governance of the SLGPS in the future.

Under the current governance structure, there should be mandatory member and employer representation on Pensions Committees

Committees and Boards would benefit from membership with greater expertise. Independent Professional Observers could be made mandatory.

Regulations confuse the scrutiny role of the Pension Board and the way in which funds consult with employers and members. Lothian believes the two roles should be more distinct. If employers and members were represented in the fund's governance, the Pension Board could be smaller and focus purely on its scrutiny role.

There should be a 'Section 95' officer for the pension funds, distinct from that for the Administering Authority. The Fund should have a distinct budget and resourcing, with agreements in place for any costs/services paid to/received from the Administering Authority.

For employers who have members in more than one SLGPS, options to consolidate membership into one fund should be promoted.

Recommendations of Scottish Government's review of governance arrangements (undertaken in 2016 by KPMG), should be implemented, particularly around clarifying roles and responsibilities and training for both the Scheme Advisory Board and Pension Boards.

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

Greater consistency in reporting, and scrutiny of such, should inform decision making by funds and policy makers and should help to improve services.

Professional involvement in governance of funds should help to ensure conflicts of interest are managed, funds comply with their fiduciary duty and improve scrutiny and decision making.

The above should generate greater confidence in the SLGPS.

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

In this review, focus should be on the interests of the members and employers in the funds, putting aside conflicts of interest.

The general lack of consistency of reporting, particularly in relation to transparency on investment costs, is hindering the debate on structure – costs are very important, but the focus should also be on governance, sustainability and risk management.

Lothian's cooperation with other funds under its FCA authorisation shows that it is possible to work together under the current fund structure. However, the governance of any new SLGPS structure, whether pooling or merger, is the most critical aspect. Our experience shows that collaboration is not effectively scalable.

In-house management is best practice for large funds with sufficient scale and governance to implement It is the clearest route to generating cost savings for SLGPS. Fund merger, alongside appropriately revised governance structures, provides the most direct route to increased in-house management.

There needs to be appropriate scrutiny of the structure of SLGPS to assess the effectiveness of any changes resulting from this review, and to ensure lessons are learned. We have concerns that without such oversight, lessons will not be learned, inefficiencies will continue and the SLGPS structure will be revisited again in the future.

The consultation questions end.