Report on the Consultation on the

Review of the Structure of the Scottish Local Government Pension Fund

Part 1: Conclusions and key issues

Carried out by the Pensions Institute

on behalf of the Scottish Local Government Pension Scheme Advisory Board

David Blake

Matthew Roy

April 2019

Contents

Contents 2
Executive summary and conclusions 3
Introduction 7
1. Conclusions 9
2. Analysis of key issues 25

About the Scheme Advisory Board

Established under the Public Service Pensions Act 2013, the Scheme Advisory Board's role is to provide advice to the Scottish Government on the desirability of changes to the design of the Scottish Local Government Pension Scheme and the implication of other policy issues.

About the Pensions Institute

Hosted by Cass Business School at City University of London, the Pensions Institute (www.pensions-institute.org) is the first and only UK academic research centre focused entirely on pensions research. Our purpose is to serve as an essential forum for pensions analysis and research, with particular emphasis on the UK system.

David Blake

Professor David Blake is the Director of the Pensions Institute and Professor of Pensions Economics at Cass Business School. He was educated at the London School of Economics, gaining a PhD in Financial Economics in 1986. David previously worked at the LSE, the London Business School and Birkbeck College before joining Cass Business School (part of City, University of London) in 2004 as a professor in the Finance Faculty. He set up the Pensions Institute in 1996.

Matthew Roy

A Fellow of the Pensions Institute, Matthew has worked in finance, policy and strategy roles in Europe and Asia Pacific. Matthew is New Zealander by birth, holding an M.Comm (1st Class Hons.) from the University of Canterbury. Beginning his career as a policy adviser he has worked in economics, securities marketing and as a journalist to international finance publications. Since moving to Scotland in 2011, he has advised global financial organisations on marketing strategy and participated in third-sector community energy projects and regeneration bodies.

Executive summary and conclusions

The 2018 consultation carried out into the structure of the Scottish Local Government Pension Scheme (SLGPS) by the Scheme Advisory Board (SAB) suggests the current scheme has a number of flaws and raises sufficient evidence that the Scottish Government should evaluate the case for mergers between funds in the scheme.

Fifty six respondents provided views in 49 responses to the consultation. The exercise was open to all constituents of the scheme,[1] and presented four options for the future structure of SLGPS: retain the current structure with 11 funds; promote cooperation; pool investments between funds or merge the funds into one or more new funds.

Respondents provided a diversity of views and actionable intelligence, which suggests that despite some limitations on the scope of this exercise,[2] the consultation can be used to inform the future structure of the SLGPS. To evaluate these views, the analysis that follows is based on qualitative assessments of the arguments made by respondents rather than the quantity of respondents making a particular argument.

Although the analysis in this report is largely to present consultees' views, the Pensions Institute provides some additional considerations on how the objectives of the scheme could guide the choices about structure; and offers views on some key issues where respondents differed on their interpretation of facts. The summary concludes with what seem to be the most pressing actions.

Views on the options

Respondents were asked to evaluate the scheme against the criteria of investment costs, governance, operating risks and ability to invest in infrastructure. Their responses show two divergent views of the current structure and its future options based both on these criteria and other factors introduced by respondents.

Thirty six respondents including nine administering authorities say they prefer the status quo or cooperation options. Although cooperation was presented as a separate option, it is shown by the consultation to be a variant of the status quo. The views of these respondents are based on a positive evaluation of the scheme against the consultation criteria. They also say the settings of the scheme such as funding and contribution rates show it is a success; the scheme is insufficiently flawed to justify the risks of structural change; and the case has not been made for other options.

Seventeen respondents, including two administering authorities, two unions, five multi-fund employers and representatives of admitted bodies say the system is not optimal when measured against the criteria, has significant flaws and should be abandoned in favour of pooling or merger. Pooling or merger would lead to benefits on the consultation criteria – an estimate in one response suggested cumulative gains of £1bn after 10 years[3] – give all scheme members access to the benefits of scale and remove the disadvantages of the scheme's administering authority based, regional structure.

---

[1] Members, employers, representative groups and organisations which administer the scheme – pension boards, committees and administering authorities.

[2] Employee representative groups were encouraged to respond on behalf of scheme employee members. The consultation relied on administering authorities and councils to invite the participation of employers and admitted bodies.

[3] Joint submission by the Lothian Pension Fund executive, Lothian Pensions Board and Pensions Committee of City of Edinburgh.

Unite was the only respondent to prefer pooling and favoured it over merger as it would not lead to job losses and retained local governance structures. The remaining sixteen respondents preferred mergers and arguments concerning mergers formed the bulk of responses that preferred structural change. Two administering authorities (Lothian and Falkirk) prefer merger into two or three funds, while most of the other respondents – multi-fund employers and national employers representative groups – prefer merger into a single fund. In the views of these respondents mergers would introduce better governance of the scheme than pooling.

Respondents explored what form merged funds should take and suggested a new model for governance that abandons the administering authority model; retention of local servicing of members and employers; adoption of internal investment management to yield the greatest cost benefits; prevention of cross-subsidies by merging assets and not liabilities; and careful transition management to avoid the difficulties experienced in other public sector mergers.

Evaluating arguments and action points

Respondents offered a wealth of evidence and recommendations that should be taken up for consideration by policy makers. The Pensions Institute limits its additional analysis of the consultation findings to an appraisal of some issues raised to assist in this evaluation along with the most pressing action points.

Evaluating arguments

When making their arguments for and against the options in the consultation, most submissions indicate that the principal purpose of council pension funds was to defer workers' pay and to provide security of income in retirement at a sustainable cost to the pension scheme sponsors. Audit Scotland provided a set of criteria that could be used to judge features of the scheme most relevant to this objective.[4]

Therefore any other arguments appear of lesser relevance, or are un-useful, in informing the future structure of the SLGPS. While the structure of the SLGPS may also offer democratic accountability, provide additional resources to local authorities or enable funding of infrastructure projects, these appear to be secondary objectives and could be dealt with by other policy instruments if viewed as priorities by government.

In the case of infrastructure investment, respondents argue convincingly that it should not inform the structure of the scheme but there could be a public policy role in increasing the supply of infrastructure investments that were suitable investments for the scheme. It remains an open question whether changing the structure of the SLGPS would increase the scheme's overall investment in infrastructure assets. If funds in the scheme were large enough to internally manage infrastructure assets, this might improve the net returns and attractiveness of these investments but the scheme liabilities will ultimately determine the appropriate portfolio weighting of such assets.

With the agreement of the SAB, the Pensions Institute conducted analysis into issues raised by responses concerning: the comparability of investment management costs; the FCA findings into institutional investment management costs; and the benefits of scale.

Transparency of investment costs: Consultees differed on what investment management costs reported by the scheme under the current guidelines showed – either low costs with minor differences between funds or significant under-reporting of costs. The Pensions

---

[4] See the Additional Comments section in Part II of this report.

Institute finds that the scheme likely significantly under-reports costs and those reported under the current guidelines cannot be relied upon to give a good picture on how well the scheme manages investment costs.

Competition: Consultees differed on what degree SLGPS funds benefit from competition in the institutional asset management market and differed whether the Financial Conduct Authority's Asset Management Market Study show there is good competition in this market. The Pensions Institute's review of material relating competition in the UK asset management sector suggests it is not a fully competitive market neither in its retail nor institutional segments. The FCA study indicates there is weak competition in the institutional asset management market. As such the SLGPS cannot place a high degree of reliance on price competition to help control investment costs in the scheme.

Scale benefits: Consultees differed on whether large SLGPS funds could expect to enjoy scale benefits and suggested past research on LGPS funds in the UK had equivocal results. Based on a wider review of UK and international evidence, the Pensions Institute believes that it is reasonable to expect that larger SLGPS funds benefit from economies of scale in the cost of investing. In the UK, larger funds are likely to have greater buying power and command lower costs and internationally, large pension funds tend to have both lower costs and generate higher returns.

Suggested actions

In the view of the Pensions Institute, the consultation raises four top priority issues for the SLGPS.

Evaluate the case for merger: The consultation raises sufficient likelihood of benefits that the case for merger of SLGPS funds should be evaluated. This is additionally required because two funds have expressed a desire to merge, while many respondents to the consultation can say with some justification that they did not have a sufficient level of detail to properly evaluate the case for merger.

Infrastructure: The consultation suggests there is a role for the Scottish Government to play in boosting the supply of Scottish infrastructure investments that are a suitable proposition for funds and further investigation should be undertaken to how this could be done. But it remains an open question whether changing the structure of the SLGPS would increase the scheme's overall investment in infrastructure assets. An investigation into this question should compare the investment requirements dictated by the scheme's liabilities and the scheme's fiduciary responsibilities to members against the degree to which the cost savings from internal management of infrastructure assets could improve the attractiveness of these investments.

Investment costs: The SLGPS should take immediate steps to improve reporting on investment management costs. The FCA's Institutional Disclosure Working Group templates should be implemented as a mandatory reporting requirement. Costs reported under the guidelines should be publicly reported and the SAB should play a role in assessing these costs against UK and international benchmarks.

Multi-employer funds: The position of multi-fund employers appears unsustainable in the current system. Large multi-fund employers could address some operational issues by shifting to an individual fund - and legislation seems to allow for this process[5] – but this

[5] Schedule 4 of the 2018 regulations allows scheme employers to apply to Scottish Ministers to substitute membership between funds. Scottish Ministers must consult with funds and any other bodies that would be affected before granting approval. In practice, the process is managed by the Scottish Public Pensions Agency.

would not resolve the other structural issues these employers have identified relating to investment costs, governance or operating risks.

Introduction to Part I

This report summarises the responses of participants in the 2018 consultation carried out into the structure of the Scottish Local Government Pension Fund (SLGPS) by the Scheme Advisory Board (SAB).

SLGPS is Scotland's largest pension scheme with currently more than 406,000 members who are employees, former employees and pensioners. It has members in local government, education, the police, the voluntary sector, environment agencies and private contractors.

The scheme is composed of 11 individual funds with assets totalling around £42bn and liabilities to members of £55bn.[6] Each fund serves a different group of employer organisations, the largest fund is Strathclyde with £19.7bn in assets and 210,000 members; Orkney Islands is the smallest, with assets of £335m and 3,663 members.[7]

The consultation asked for views on four options for the future structure of SLGPS. These options compare the advantages and disadvantages of retaining the current structure of the scheme without change or, by degrees, consolidating the scheme's 11 constituent funds:

1) Retain the current structure with 11 funds

2) Promote cooperation in investing and administration between the 11 funds

3) Pool investments between the 11 funds

4) Merge the 11 funds into one or more new funds.

Background

The four options were developed as part of an ongoing review into the SLGPS by SAB. The board was required to carry out the review when it was established by statute in 2015 with a mandate to provide advice to the SLGPS and the Scottish Government.[8]

In 2017, SAB's review concluded that the scheme faces a number of significant challenges and the current structure of the scheme with its 11 funds should be re-considered as a result. The findings of the review were presented to Scottish Ministers in May 2017 by SAB. In January 2018, Derek Mackay MSP, Cabinet Secretary for Finance and the Constitution requested that a consultation with SLGPS administrators, employers and employee membership bodies be carried out on the four options.

The consultation was carried out on SAB's behalf by Pensions Institute, an academic research organisation hosted by City University of London. The consultation period was June through December of 2018.

---

[6] The SLGPS also includes five additional funds including transport funds and the Scottish Homes Pension Fund which are managed by the 11 administering authorities.

[7] All figures dated 31 March 2017.

[8] A summary of this review is contained in the consultation terms of reference, *Consultation on the Review of the Structure of the Scottish Local Government Pension Fund*, which can be found at SAB's website at lgpsab.scot/consultation2018.

How the findings are reported

The findings in this report are based on returns by 56 respondents and organised into two parts. This is Part I of a two part report. Part II contains detailed findings, analysis of respondents, arguments for options and additional comments.

Part I: Conclusions

Responses are summarised into findings and key issues raised by respondents are analysed.

1. **Conclusions**: The conclusions each option are summarised against the cost of investing, governance, operating risks and infrastructure consultation criteria. Reasons for supporting or opposing each option are summarised

2. **Analysis of key issues**: With the agreement of the SAB, the Pensions Institute conducted analysis into issues raised by responses concerning: the comparability of investment management costs; benefits of scale; and the FCA findings into institutional investment management costs.

1. Conclusions

Summary conclusions for each option are presented beginning with the overall case, following with findings related to the scheme criteria of investment costs, governance, operating risks and infrastructure.[9] In evaluating respondents' views, the analysis that follows is based on a qualitative assessment of the arguments made rather than on the number of respondents making a particular argument.

Option 1: Retain the current structure with 11 funds

The consultation reveals two divergent views supporting and opposing the current structure based on the scheme's approach to investment costs, governance, operating risks and infrastructure management as well as other factors such as the scheme's current settings in the form of contribution rates, net returns and funding levels.

The case for the status quo

Thirty six respondents including nine administering authorities say they prefer the status quo or a variant in the form of cooperation because the current settings of the scheme show it is success; the scheme is insufficiently flawed to justify the risks of structural change; or the case has not been made for other options. The singular position of the Strathclyde Pension Fund was also raised.

Scheme conditions: Many respondents said 'if it isn't broken, don't fix it'; the SLGPS is a success story and so the status quo should be preferred. Responses cited the scheme's funding level; scale; industry awards; costs; performance; quality of external fund managers; employee participation rates; and governance. A regional structure offered risk diversification and the ability of small funds to invest nimbly could be weighed against reduced access to economies of scale. Local ownership was a key ingredient in the scheme's performance, controlling costs and sustaining governance.

Case has not been made for other options: Respondents said that there was insufficient empirical evidence of the benefits of scale in investment costs or performance from the other options to justify the risks to investment performance, member participation, funding, employee contribution rates, or local conditions. This perceived lack of evidence applied to analysis of scale benefits of funds in the scheme currently, the experience from pooling in the England and Wales LGPS, and other options in the review. As part of this, some responses said several smaller and medium funds already enjoyed scale benefits so other options presented insufficient advantages to justify change. Changing the structure of the scheme would not resolve all the challenges it faces currently; earlier reforms needed time to bed in and incremental changes were preferable.

Strathclyde: Several responses noted that Strathclyde Pension Fund with £21.5bn in assets had a singular position as the scheme's only very large fund – or largest fund by a considerable margin. Scale benefits for Strathclyde were seen as limited, the fund could already directly invest in infrastructure and the fund itself suggested that additional scale could bring diseconomies.

The case for changing the status quo

---

[9] More detailed conclusions are contained in the Findings section of Part II of this report.

Seventeen respondents, including nine administering authorities, the two unions, five multi-fund employers and representatives of admitted bodies says the system is not optimal, has significant flaws and should be abandoned in favour of pooling or merger. All scheme members should have access to the benefits of scale and the scheme's regional structure was a disadvantage.

Status quo not optimal: Responses acknowledged the stable financial position of the scheme but argued that this was not optimal, with rising contribution rates, falling employer participation, treatment of cessation liabilities, conflicts of interest caused by the administering authority model and the protection of benefit levels being of particular concern. The fiduciary duty of funds should compel them to actively consider if alternative structural options best serve their members. The current stable financial position of the scheme presented a better time for structural change than in response to a crisis.

Benefits of scale: Respondents argued that smaller funds in the SLGPS did not benefit from lower investment fees and other economies enjoyed by the scheme's large funds, such as the ability manage funds in-house, hire skilled employees to manage operating risks or to directly invest in complex assets such as infrastructure. Smaller funds were seen as less able to deal with challenges facing the scheme relating to governance, reporting, rising regulatory overheads and operating risks.

Disadvantages of regional structure: Responses said the regional structure of the scheme had disadvantages and was a particular problem for multi-fund employees and third-sector admitted bodies. A regional structure was seen as a barrier for funds to implement best practices, apply consistent policies and access specialist skills as well as heightening funds exposure to budgetary and conflict of interest risks from administering authorities. A regional structure posed high interaction costs for multi-fund employers and they were at risk of being treated as closed employers in funds where they had few employees.

Findings: Investment costs

Investment costs in the SLGPS are uncertain: Although managing investments currently generates more than 90% of the scheme's costs on some estimates, the consultation suggests the SLGPS currently does not have a good gauge of the fees it pays to external managers and evidence presented suggests that larger funds should, in principle, be better able to manage costs and enjoy scale benefits.

Some arguments for the status quo assume costs reported by the scheme are accurate: Supporters of the status quo say that data reported by funds and collated by Audit Scotland show costs are low, stable and that variations between funds are minor and unimportant. Costs are low and stable because fees from external fund managers are kept under control by the scheme's administrative arrangements and competition in UK institutional asset management market.

Costs are likely under-reported in the SLGPS: Opponents say that external management costs currently reported cannot be relied on because the CIPFA guidelines used by the scheme are inadequate and as a result, the SLGPS significantly under-reports costs. If more transparent data were available, costs would be shown to be much higher. Small, basis point differences in fees were shown to be significant because they lead to million pound differences in costs.

The Pensions Institute's review of material relating competition in the UK asset management sector suggests it is not a fully competitive market neither in its retail nor institutional segments.[10] As such the SLGPS cannot place a high degree of reliance on price competition to help control investment costs in the scheme.

The Pensions Institute's review suggests that the fees disclosed by asset managers in the UK are not transparent and therefore the SLGPS cannot rely on the data currently reported under the system to assess how well the scheme manages investment costs or make comparisons between funds.[11] Costs are likely under-reported. However, this situation is likely to improve if the scheme and funds adopt the Institutional Disclosure Working Group templates.

Larger funds have advantages in procuring investments over smaller funds: Despite the scheme's administrative controls, larger funds with more resources and buying power should be able to command lower fees from external managers who customarily charge fees in tiers with lower fees for larger mandates. Larger funds could also choose to manage funds internally at a significantly lower cost than fees charged by external managers.

Based on our review the Pensions Institute believes that it is reasonable to expect that larger SLGPS funds benefit from economies of scale in the cost of investing. In the UK, larger funds are likely to have greater buying power and command lower costs and internationally, large pension funds tend to have both lower costs and generate higher returns. Although pension funds can become subject to diseconomies of scale, SLGPS funds in aggregate are small on an internationals scale, and are therefore unlikely to reach the threshold where these dis-benefits would apply.[12]

What the scheme could do better: Respondents generally agreed that the scheme could improve reporting on investment management costs. Compliance with existing reporting guidelines should be mandatory, some suggested reforms to CIPFA guidelines and most agreed investment costs of all funds should be publicly shared and benchmarked.

Findings: Governance

Regional governance of SLGPS is not optimal: The consultation suggests that the SLGPS is good at adhering to the governance requirements presented to it through local government acts and regulations, but there are problems created by the scheme's model of governance by administering authorities with lead employers along regional lines.

Scheme is largely compliant: The evidence presented suggested that the scheme as a whole is in compliance with its existing legislative and regulatory requirements. Key items were the absence of issues raised in annual audits of LGPS funds by Audit Scotland and the positive outcome of the 2016 KPMG review.

[10] See the report section: *Key Issue: Competition in investment management for LGPS funds*

[11] See the report section: *Key Issue: Transparency of investment costs*

[12] See the report section: *Key Issue: Scale benefits and the SLGPS*

Some believe the regional system manages conflicts and provides local benefits: Views diverge on the effectiveness of the SLGPS model of governance. Supporters of the status quo said the current regional model ensures local participation and provides administering authorities and their regions with economic benefits from the funds' administrative activities, in particular, through employment of those working for the funds and mitigates any potential conflict in the dual role of administering authorities as pension fund managers and employers. A mixture of training, external advice, administrative support and the introduction of pensions boards ensured the scheme had the expertise required for governance.

But local benefits are secondary to providing pensions: However, in the course of responding, most submissions said that the principal purpose of council pension funds was to defer workers' pay and to provide security of income in retirement at a sustainable cost to the pension scheme sponsor. While the structure of the SLGPS may also offer democratic accountability, provide additional resources to local authorities or enable funding of infrastructure projects, these appear to be secondary objectives to this main goal. Therefore, they appear of lesser relevance in informing the future structure of the SLGPS. Audit Scotland provide a set of criteria that could be used to judge features of the scheme most relevant to scheme's objectives of using deferred pay to provide security of income in retirement.[13]

Administering authority model is problematic: Submissions also suggested the administering authority model gave an outsize role in governance to administering authority 'lead' council employers, who hold the majority of pension committee seats, and could lead to unresolved fiduciary conflicts. Council policies can directly affect the governance of funds by dictating board hiring practices and the budgets available to administer funds. It was suggested that the capabilities of pension boards and committees fluctuate with the electoral turnovers of councillor members. Multi-fund employers said that the regional differences made it difficult to participate in governance and charities said it led to inconsistencies in the treatment of employers in the form of arrangements for cessation liabilities for admitted bodies.

Findings: Operational risks

Most respondents generally believed they had access to information about operating risks of the funds in the SLGPS and were well informed. Where respondents felt they were less well informed, it was because they were employers with insufficient resources to monitor funds, or because they were aware that smaller funds may have fewer internal resources to manage operating risks.

Persisting skills concerns: Respondents believe the SLGPS has strong controls, systems and processes, but some identified concerns with the availability of skills and use of external advice. For example, some funds relied on investment strategy advice from external fund managers.

Regional structure: Respondents were divided on whether each fund having its own approach to operational risk management helped or hindered, while significant issues with the treatment of cessation/termination liabilities for admitted bodies were raised.

Improvements: Respondents proposed various ways of improving operational risk management including: standardisation and benchmarking of risk reporting; benefits simplification; improvements to staffing, processes and systems; and mandated consistent adoption of cessation reporting standards and liability accrual.

---

[13] See the Additional Comments section in Part II of the report.

- *Standardised reporting:* Respondents proposed greater standardisation and disclosure of the risk register and fund performance reporting, including a framework of standards expected of the SLGPS to measure performance against. It was also proposed that SAB should collate and publish risk registers annually.

- *Benefits simplification:* Many respondents suggested simplifying benefits regulations as reducing operational risks, citing the complexity involved in administering three benefit schedules (1/80th, 1/60th, 1/49th), differing discretions, 30 contribution rates, certificates of protection and aggregation rules.

- *People, processes and systems:* Respondents suggested systematic sharing of best practice; greater training and better management of key person risks, variously for governance personnel, administrators, decision makers and members of SAB. Administering authorities could gain benchmarking information by consolidating their use of the Aquila Heywood Altair LGPS software onto the cloud.

- *Cessation/termination regulations*: Robertson Trust and SCVO recommended better transparency and communication for the treatment of cessations. This includes implementing the proposals made by the Institute of Chartered Accountants of Scotland in September 2017 and requiring funds to act on updated LGPS legislation in 2018. Funds should provide admitted bodies with an estimated cessation valuation and explanation in line with FRS102 disclosure requirements.

Findings: Infrastructure

Responses largely recognised the benefit to funds of investing in infrastructure – in particular, for funds with mature liabilities to match against the lower risk, long-term, inflation-linked income of infrastructure investments. But they were clear that, although there was a policy role of increasing the supply of suitable infrastructure investments, they were opposed to any political interference that would conflict with the aims of the scheme and its fiduciary duties.[14]

Larger funds have better access: Responses suggested that larger funds had better, or cheaper, access to infrastructure investment. Collaboration was presented as a means for smaller funds to gain access to infrastructure.

Improving availability of infrastructure: Many responses suggested improving the supply of investments that were a 'suitable proposition' for funds and providing vehicles accessible by small funds. This included looking at Scottish Futures Trust proposals on pooled housing infrastructure investments, or a role for government establishing investment vehicles that provided the risk-return characteristics required by funds. Direct cooperation with public bodies that might require infrastructure finance was mooted.

Suggested actions:

Investment costs: The SLGPS should take immediate steps to improve reporting on investment management costs. The FCA's Institutional Disclosure Working Group templates should be implemented as a mandatory reporting requirement. Costs reported under the guidelines should be publicly reported and the SAB should play a role in assessing these costs against UK and international benchmarks.

---

[14] Respondents said that raising the scheme's investments in infrastructure should not be used as a criteria to inform any option for the future structure of the SLGPS.

Multi-employer funds: The position of multi-fund employers appears unsustainable in the current system. Large multi-fund employers could address some operational issues by shifting to an individual fund - and legislation seems to allow for this process[15] – but this would not resolve the other structural issues these employers have identified relating to investment costs, governance or operating risks.

Infrastructure: The consultation suggests there is a role for the Scottish Government to play in boosting the supply of Scottish infrastructure investments that are a suitable proposition for funds and further investigation should be undertaken to how this could be done. But it remains an open question whether changing the structure of the SLGPS would increase the scheme's overall investment in infrastructure assets. An investigation into this question should compare the investment requirements dictated by the scheme's liabilities and the fiduciary responsibilities to members against the degree to which the cost savings from internal management of infrastructure assets could improve the attractiveness of these investments.

[15] Schedule 4 of the 2018 regulations allows scheme employers to apply to Scottish Ministers to substitute membership between funds. Scottish Ministers must consult with funds and any other bodies that would be affected before granting approval. In practice, the process is managed by the Scottish Public Pensions Agency.

Option 2: Cooperation

Cooperation was preferred by many respondents because it was a means of preserving the current structure of the scheme, while potentially offering a route to yield some improvements in investment costs, governance, operating risks or the scheme's capacity to invest in infrastructure.

But funds leading cooperation efforts suggested it was difficult to scale and could require participants to relinquish control over investment decisions and adopt internal investment management. Others said cooperation retains the disadvantages of a regional structure and could be sub-optimal compared to pooling or merger. Some said the limited extent of cooperation in the current system despite its apparent benefits, may show that reforms to the SLGPS need be compulsory.

The case for cooperation

Respondents said cooperation offered benefits to smaller funds through reductions in costs and sharing of resources. Some said that existing collaboration between funds or participation in national frameworks showed that the cooperation model worked for the SLGPS. But there were differences between respondents in how cooperation could be pursued:

Incentivised or compulsory: Many respondents said cooperation should be pursued for its benefits either, in its own right, or, in tandem with structural change, but only in conjunction with incentives or compulsion to ensure all funds were actively engaged. Otherwise it would just reflect the status quo and not yield any change to the SLGPS. Many respondents who were otherwise supportive of the status quo in the SLGPS felt that incentives or compulsion was necessary for cooperation to be of benefit, while respondents who preferred pooling or merger said compulsory cooperation could yield significant benefits in the short-to-medium term while structural change was implemented. The Robertson Trust–SCVO response suggested that existing cooperation between funds was in fact relatively limited despite clear benefits suggesting compulsion was required.

Reflects the status quo: However, some respondents preferred cooperation because it represented the status quo. They felt cooperation should be voluntary, or incentive based, as it gave them the greatest degree of freedom to address their members' interests. Voluntary cooperation would also avoid the disadvantages of pooling or merger, revisiting a reason for supporting Option 1 that there was apparently insufficient empirical evidence of the benefits of scale in investment costs or performance from the merger or pooling to justify the risks to investment performance, member participation, funding, employee contribution rates, or local conditions.

Frameworks to assist cooperation: Several responses, including Strathclyde Pension Fund, suggested some re-organisation of the scheme could assist cooperation. Key elements in the Strathclyde response include: an active programme to promote joint investment, procurement and resource sharing; joint activity on ESG issues; shared administration and communications; additional resources for SAB or funds; a formal fund conveners' meeting; and establishment of three hubs for the north, west and east of Scotland. Additional suggestions for cooperation outside this framework included administrative activities such as publishing; joint procurement of the Aquila Heywood Altair Pension Administration system and member education. Respondents also suggested beefing-up SAB to add impetus to cooperation, and although the means were not specified, it was suggested the board have a greater ability to compel funds to participate in cooperation frameworks or adopt transparency measures.

The case against cooperation

Respondents identified problems for cooperation, including that it could be difficult to scale, could require additional funds before it would be economic to adopt internal management, retains regional disadvantages and could be sub-optimal compared to pooling or merger.

Scaling problems: The Lothian model of cooperation was frequently cited as evidence that the SLGPS could pursue cooperation to the benefit of the scheme's investment costs, governance, operating risks and infrastructure investment. But some participants in the arrangements had doubts whether the Lothian model could scale widely in the scheme. Respondents said cooperation took significant time to establish and required a high degree of delegation that could be unpalatable to some funds. The Lothian Group[16] felt that a significant element of its cooperation arrangements – the joint investment strategy panel with the Falkirk and Fife funds – would not scale beyond its existing membership of three participants. Other responses suggested that separating fund governance from administering authorities – an independent executive – would be necessary for this cooperation to be scalable.

Requires funds to adopt and share internal investment management. Edinburgh Leisure suggested that because 92% of fund costs are investment management fees, cooperation would be sub-optimal unless funds brought investment management in-house and then shared their internal managers as part of cooperation agreements. This was also true for pooling and mergers. The response recognises that most funds are too small to bring funds in house, so a potential implication of this response is that one or more additional large SLGPS funds would need to bring funds in-house, otherwise any cost saving from cooperation would be limited.

Doesn't address the disadvantages of regional structure: Multi-fund employers suggested that, unless cooperation led to homogeneity between funds with a single point of administrative contact, it would not resolve their difficulties with the high interaction costs caused by the regional footprint of the scheme nor the risk of being treated as closed employers.

Sub-optimal compared to other options: Some respondents acknowledged the benefits of cooperation, but said it still remained sub-optimal compared to pooling or mergers. These revisited the arguments presented against the status quo in Option 1, including that it was better to make changes to the scheme under good conditions and that scale benefits were not enjoyed by all participants in the current set-up. There have been some very impressive attempts to make small changes on a cooperative basis, as the Lothian model shows. But, equally, Lothian also shows the limits to the cooperation model, in particular, the difficulties in scaling up. The Robertson Trust–SCVO response confirms what must be the reality: the existing cooperation model is 'in fact relatively limited despite clear benefits suggesting compulsion was required'.

Findings: Investment costs

On balance, responses suggest that cooperation would have limited impact on reducing the investment costs of the scheme, unless highly specific forms of cooperation were adopted involving one or more funds making available their internal investment management function to others in an arrangement that bears a marked similarity to pooling. Other forms of cooperation were likely to be of most benefit to smaller funds, but these were the funds with the least capacity to enter into cooperation.

---

[16] Joint response by the Lothian Pension Fund executive, Lothian Pensions Board and Pensions Committee of City of Edinburgh

Findings: Governance

Respondents agreed funds would need to align their governance structures to pursue cooperation, perhaps to the extent of delegating investment strategy implementation and fund manager selection. Such structures could dilute local governance and shift more decision-making authority to executives. Cooperation may not reduce governance overheads, but some responses suggested additional benefits through shared resources.

Findings: Operating Risks

Responses produced little consensus on whether cooperation would improve or worsen the management of operating risks in the scheme. Although funds could rely on their existing arrangements to manage operating risks from cooperation; it was uncertain whether clubbing together with others would yield efficiency or effectiveness benefits; and there were a set of new risks to manage, mostly in relation to preventing the failure of governance agreements.

Findings: Infrastructure

Respondents were uncertain whether cooperation would increase direct infrastructure investment by the scheme. Incentives, such as model arrangements would be required to increase investment by large funds, which already had substantial investments. Although cooperation would likely assist smaller funds to access direct investments, this might not be by a significant magnitude in relation to the scheme as a whole. Care would need to be taken managing potential conflicts of interest relating to local investing.

Option 3: Pooling

The case for Option 3: Pooling

Unite was the only respondent to prefer pooling, but several respondents discussed the case for pooling; some describing it as a minimum required reform. Unite preferred pooling over merger in that it would not lead to job losses; allowed spreading of risks; improved SLGPS buying power; retained local governance structures; and reduced administration costs. When discussing the case for pooling, key considerations respondents discussed were:

Single or multiple pools: Respondents differed on whether there should be single or multiple pools. Unite preferred three or four pools, other respondents suggested that pools would need to at least £25bn in size to gain investment scale benefits, the Police Scotland–Police Authority Scotland response suggested a number of pools that would allow for the different investment strategy needs of funds in the scheme. This response gave as an example funds with a stronger funding position preferring a pool with a low risk investment strategy. Some respondents who preferred multiple pools also said a single pool could have more challenging governance requirements. The Robertson Trust–SCVO response suggested that a single pool at £42bn in assets would not be excessively large. It would be roughly double the size of the existing largest fund, Strathclyde, but similar in scale to three of the English pools and larger than the three of the others.

Voluntary or compulsory: Some respondents supported the idea that pooling could be promoted as a voluntary option where it met the requirements of different funds. Strathclyde Pension Fund for instance, already enjoys scale benefits so should not need to pool. Other funds might need the freedom to select pools with complementary risk-return profiles or to access specific asset classes such as infrastructure. It was not clear how voluntary pools should reach the thresholds where scale benefits became available.

Governance, costs and internal management: Responses suggested that pooling would need to be internally managed to deliver meaningful cost reductions and prevent overly bureaucratic governance. Unite's response said that lack of oversight and control in governance, and lower-than-expected cost savings in England and Wales showed that pools in Scotland should be internally managed. Other respondents said not implementing an additional layer of governance between the fund and the investment manager was the key for pooling to have more success than England and Wales. Edinburgh Leisure's argument relating to cooperation applied, which because investment management fees make up 92% of scheme costs, meant pooling would be sub-optimal unless funds brought investment management in-house.

The case against Option 3: Pooling

Arguments against pooling suggested that the scheme conditions didn't justify change; the case hadn't been made for pooling; internal management offered surer cost savings; pooling could lead to national concentration of risks; and pooling didn't resolve admitted bodies' problems with cessation.

Scheme conditions: Respondents revisited the 'if it isn't broken, don't fix it' position in favour of Option 1 that the SLGPS is a success story and so the status quo should be preferred.

Case has not been made for pooling: Some respondents said that they hadn't been presented with a clear case that allowed them to evaluate the advantages and disadvantages of pooling and so it was not possible to make an informed response. In general, respondents revisited the argument in favour of Option 1 that that there was

insufficient empirical evidence of the benefits of scale in investment costs or performance from pooling to justify the risks to investment performance, member participation, funding, employee contribution rates, or local conditions.

Respondents said that pooling in England and Wales suffered from a lack of a standardised approach or clearly planned strategy; lower-than-expected savings; long payback periods; stripping of skilled employees from administering authorities to set up pools; and significant governance problems. The structure of the SLGPS where one fund – Strathclyde – holds roughly half the assets was said to be significantly different that evidence in England and Wales might not apply. Although a Scottish approach to pooling was being developed by the Scottish Futures Trust, it was focused on infrastructure and property and in its infancy.

Internal management should be pursued first: Some responses thought the SLGPS should focus on moving management in house as a surer means to generate cost savings than pursuing pooling.

Concentration of risk versus benefits of regional diversity: Some respondents suggested pooling could create a single point of failure for the SLGPS and that the existing regional structure offered diversification benefits.

Retains segregated liabilities, so leaves cessation issues unresolved: The Robertson Trust-SCVO response said pooling would not resolve the cessation issues encountered by charitable and admitted bodies because pooling would preserve specific employer responsibility for liabilities with funds retaining their allocations of assets and liabilities.

Findings: Investment costs

On balance, responses suggest that pooling would most likely deliver savings if it were based on internal management of pools or if pools were large enough to reach the lower fee thresholds of external managers. If pools were to be externally managed, they might benefit small funds only. Many respondents couldn't foresee any cost savings; some said there was an absence of evidence for benefits, or thought pooling could lead to market concentration and reduced investment effectiveness.

Internally managed pools: The Lothian Group said internally managed pools could offer significantly lower costs than externally managed pools. The group suggested if pools achieved the costs of the Lothian Pension fund, SLGPS investment costs would be 80% lower leading to substantial cumulative benefits. If the SLGPS pools could lower their expense ratio from 0.47% currently to the level of the University Superannuation Scheme at 0.31% then the scheme could save £65m annually.

Externally managed pools: Externally managed pools would most likely be of benefit to small or medium funds by lowering costs or broadening portfolios. But large funds would be unlikely to benefit: Strathclyde Pension Fund said it already pays the lowest fee tier offered by external managers. Responses indicate externally managed pools would also need to exceed particular thresholds in particular assets classes to reduce costs and thus would need to be compulsory. Falkirk Council Pension Fund gave as an example an external manager fee quotation of 0.54% for a £100m global equity strategy mandate and 0.39% for a £1b mandate. Others suggested a minimum size of £25bn for scale advantages based on the experience of LGPS pooling in England and Wales

Findings: Governance

The complexity of pool structures potentially raised governance issues; respondents disagreed on whether these could be resolved, but Scotland could learn from the experience in England and Wales. Overall, responses balanced the benefits of retaining local influence and stakeholder involvement, while gaining skilled resources and scale by pooling against risks associated with complexity; retention of duplicate structures and diseconomies of scale.

Pooling could allow the scheme to retain existing local governance arrangements but at the cost of maintaining duplicate governance structures. Under pooling, investment decisions could improve with the benefit of greater specialist influence or worsen through complexity and insufficient granularity. Savings from the operation of pools in the long-term would need to be sufficient to absorb the set-up and running costs of pools. Pooling could introduce new governance risks, including internal manager capture and dilution of stakeholder influence in favour of executives.

Findings: Operating Risks

Overall responses were unclear whether pooling raised or lowered operating risks. Potential new risks were identified in setting up pools, oversight and investment strategy, but so were risk reducing factors in access to staff with specialist skills, manager selection processes and diversification.

Findings: Infrastructure

Respondents thought pooling might not create additional capacity in the SLGPS to invest in infrastructure, but could lead to higher investment as pools could offer greater scale and better packaged investments to suit scheme funds.

Creating new pools for SLGPS funds: Respondents discussed the merits of creating new infrastructure pools dedicated to SLGPS funds as opposed to pooling funds in their entirety. Some respondents suggested such pools could provide investments packaged to meet the risk, inflation and maturity characteristics desired by SLGPS funds; sources for this idea included the Pensions Infrastructure Platform and the Scottish Futures Trust report which suggested that Scottish real estate might be a good investment for LGPS funds.

Option 4: Merger

The case for mergers

Some 16 respondents suggest the SLGPS fund should merge because it would lead to benefits for investment costs, governance, operating risks and infrastructure investment. The two administering authorities (Lothian and Falkirk) prefer merger into two or three funds, while most of the other respondents - multi-fund employers and national employers representative groups prefer merger into a single fund. They offered the following additional considerations on mergers:

Compulsory mergers when a business case was present: Some respondents said that funds could be directed to merge if a business case, risk assessment and due diligence that demonstrated merger would be in the best interest of all members and employers. This business case should include timescales, costs of implementation and modelling of the impact on the affordability of the LGPS in the medium–long term, as well as analysis of the impact on the funding levels of the schemes, including the actuarial basis of the analysis and the funds' demographic profiles. This analysis should focus on the net bottom line impact on the fund and ensure no diminution in service levels to employers.

Voluntary mergers when a business case is present: Some respondents said voluntary mergers should be encouraged until the Scottish Government chose to make them compulsory. Lothian Pension Fund and Falkirk Council Pension Fund Two said they wished to build business cases and explore mergers between the funds. If a policy of voluntary mergers were pursued, then it was proposed the SAB should schedule a review in five years that would lead to enforced mergers for funds that cannot meet best practice standards set by the body

Status quo not optimal: As with Option 1, responses acknowledged the stable financial position of the scheme but argued that this was not optimal, with rising contribution rates, falling employer participation, treatment of cessation liabilities, conflicts of interest caused by the administering authority model and the protection of benefit levels being of particular concern.

Benefits of scale: Respondents suggested that fund mergers had been successfully conducted in the past so the model was in fact tested. The merger of county and town council funds during local government re-organisation in 1975 and the creation of the South Yorkshire Pensions Authority were cited as examples. As with Option 1, respondents argued that mergers should be pursued because some funds in the SLGPS did not benefit from lower investment fees and other economies enjoyed by the scheme's large funds, such as the ability manage funds in-house, hire skilled employees to manage operating risks or to directly invest in complex assets such as infrastructure.

Preferable to pooling due to governance: Respondents said mergers were preferable to pooling because they did not introduce an additional governance layer which came with the potential for poorer or less accountable decision-making.

Resolves disadvantages caused by regional structure: As with Option 1, respondents said merger could resolve the difficulties caused by the scheme's regional structure including consistency issues for admitted bodies, administrative issues for multi-fund employers, and the risk of multi-fund employers being treated as closed employers in funds which they had fee employees.

The case against mergers

In making the case against mergers, respondents said the scheme favourable conditions meant change was not necessary and a detailed case for merger hadn't been presented to them. They said mergers could lead to cross subsidisation of liabilities; loss of local governance; reduced administrative capacity and had a high risk of failure in the public sector.

Scheme conditions: Respondents revisited the 'if it isn't broken, don't fix it' position in favour of Option 1 that the SLGPS is a success story and so the status quo should be preferred.

Case has not been made for merger: Some respondents said that they hadn't been presented with a clear case that allowed them to evaluate the advantages and disadvantages of merger and so it was not possible to make an informed response. In general, respondents revisited the argument in favour of Option 1. Strathclyde Pension Fund said that size and scale benefits were not necessary a determinant of success. The UK's two largest pension schemes – British Telecom Pension Scheme and USS – each had deficits of more than £10bn.

Cross subsidisation of liabilities: The potential for cross subsidisation of liabilities to raise contribution rates for employers of better funded funds was a significant concern for many respondents. Some respondents said that employers were highly sensitive to contribution rates so increases could lead to job losses or a reduction of employers in the scheme.

Loss of local governance: Respondents said mergers would reduce their participation in governance and that a merged scheme could lead to lower participation from particular stakeholders such as admitted bodies, employers and unions. Some said that local governance was integral to the successful performance of funds.

Reduced administrative capacity: Some respondents said mergers could make it difficult for former administering authorities to manage other financial matters.

The public sector is unable to conduct mergers effectively: Respondents said that public sector mergers perform poorly and this risk was high for mergers in the SLGPS due to the scheme's administrative complexity.

Findings: Investment costs

Respondents presented some analysis on how mergers could reduce investment costs, but many said they had not seen practical evidence or required a more detailed case before they could make an informed evaluation.

Case for economies: The Lothian Group[17] estimated the scheme could make annual savings of £65m, leading to cumulative gains of £1bn by year 10, if merged funds adopted internal management like other large funds globally, bringing costs in line with the expense ratio of the UK's largest fund – the Universities Superannuation Scheme. Although the largest fund – Strathclyde – may not benefit, other funds could also gain access direct investments which previously had high entry costs and reduced the use of expensive investment vehicles. Falkirk Fund with £2.3bn in assets said that every reduction in fees of 5bps (0.05%) translated into annual saving of c£1.2m. UNISON cited the APG study suggesting the

[17] Lothian Pension Fund executive, Lothian Pensions Board, Pensions Committee of City of Edinburgh

presence of a single merged fund in Scotland would have deliver annual benefits of £830m with each basis point saving the scheme £3.5m.

Case against economies: Some respondents suggested that there was insufficient evidence that larger funds had lower costs or produced better returns than smaller funds and there was no certainty to where the tipping point where economies of scale could be achieved, so mergers did not guarantee real benefits. SLGPS funds may already enjoy scale benefits or have benefited from fee savings passed on from reforms in England and Wales. The SAB's snapshot analysis of the LGPS 2015 accounts by Mercer for the SAB was cited as showing that larger funds do not always have lower costs and perform better and Audit Scotland analysis of fees were said to show that SLGPS funds did not have significantly different investment costs.

Findings: Governance

Responses contrasted the benefits for governance of the greater resources available to large funds, and consistency of approach, against the potential for a loss of input by regional stakeholders. Larger merged funds might enjoy improved governance as they were better resourced and the scheme as a whole might benefit from greater consistency of governance from a fewer number of large funds. The new governance structures of merged funds might share governance among a wider set of stakeholders than currently. But some said merged funds might allow less local input and reduce the influence of particular stakeholder groups such as employers. the current governance arrangements could be intrinsic to the successful performance of funds.

Choice of governance model: Respondents said merged funds would need new governance structures and suggested joint boards or a pensions authority as models. The model chosen would depend on whether the scheme merged into a single or reduced number of funds. Reducing the dominance of administering authority councils and the inclusion of other councils and employers was seen as a benefit of this approach.

Findings: Operating Risks

A scheme with merged funds could have better resources to manage operating risks than it does currently, but some said a trade-off could be greater concentration of risks. The merger process would carry execution risks, including administration and member servicing concerns that would require a management strategy. Former administering authorities may face risks caused by loss of financially knowledgeable staff.

Findings: Infrastructure

Respondents disagreed on the impact mergers would have on infrastructure investment by the scheme. Although larger funds might have a greater appetite for infrastructure, the scheme could already be investing close to capacity with additional gains limited. Merged funds could be subject to diseconomies and political risks. Public policy measures would be needed to generate the larger scale infrastructure investments that merged funds might require.

Findings: Considerations for mergers

Respondents explored how mergers should be conducted, what form merged funds should take and the best number of merged funds for the scheme. Among the key considerations were:

- *Governance*: A new model would be required and merged funds should abandon the administering authority model.

- *Local servicing*: To retain administrative effectiveness, merged funds should retain local servicing of members and employers.

- *Internal management:* Mergers are likely to yield the greatest benefits if funds are managed in-house.

- *Merger into a single fund or two to three large funds*: A single fund would be of international scale and able to access global best practices, while merger into two to three funds might retain a degree of local autonomy.

- *Prevention of cross-subsidies:* Mergers of the SLGPS should protect the funding positions of existing employers, so those in better funded schemes should not face a rise in contribution rates as a result of merger from funds with lower funding levels.

- *Management of execution risks:* Mergers would need careful transition management and appropriate resourcing to avoid difficulties experienced in other public sector mergers.

Suggested actions:

Evaluate the case for merger: The consultation raises sufficient likelihood of benefits the case for merger of SLGPS funds should be evaluated. This is additionally required because two funds have expressed a desire to merge, while many respondents to the consultation can say with some justification that they did not have a sufficient level of detail to properly evaluate the case for merger.

2. Analysis of key issues

The Pensions Institute is very pleased to be involved in this consultation exercise. We appreciate the thoroughness of the responses. We see our main role as summarising the responses in a neutral and objective way. Our analysis is based on a qualitative assessment of the arguments made rather than on the number of respondents making a particular argument.

Nevertheless, with the agreement of the SAB, in this section we critically appraise some of the arguments presented and provide some empirical evidence on some of the issues raised. These are not intended to be a recommendation on which of the options is best suited for SLGPS but to assist in evaluating the arguments and issues raised.

The Pensions Institute, conducted additional analysis into issues raised by responses concerning:

1. How comparable are the investment management costs currently reported in the scheme?

2. To what degree do LGPS funds benefit from competition for institutional investment management costs?

3. How reasonable is it to expect scale benefits for large LGPS funds?

Key Issue: Transparency of investment costs

How comparable are the investment management costs currently reported in the scheme?

The Pensions Institute's review suggests that the fees disclosed by asset managers in the UK are not transparent and therefore the SLGPS cannot rely on the data currently reported under the system to assess how well the scheme manages investment costs or make comparisons between funds. However, this situation is likely to improve if the scheme and funds adopt the Institutional Disclosure Working Group templates.

The UK asset management market was placed under the regulatory microscope following the 2008 financial crisis which raised questions about the value of the sector to the wider economy.[18] The management of assets held on behalf of institutions has come in for special scrutiny both in the UK and internationally.[19] The sector's reporting of costs and fees has been subject to new regulation stemming from MiFID II and the Asset Management Market Review along with many other aspects of the asset management market including stewardship, governance[20] and competition.

Following this regulatory programme, which is still ongoing, there is now a broad consensus that the disclosure of costs and fees by the UK asset management market is not transparent. In the context of the SLGPS, these findings are sufficiently clear to remove the ambiguity

---

[18] For example, The Kay review of UK equity markets and long-term decision making, Final Report, July 2012.

[19] https://www.fca.org.uk/publications/market-studies/asset-management-market-study; https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir

[20] http://redlinevoting.org/

created by earlier work analysing the costs and fees of scheme funds which could be critiqued on the quality of their data and the time periods of analysis.[21]

The transparency issues identified by the regulatory programme have implications beyond reporting. One implication is that UK institutions cannot make completely informed choices about asset allocation based on information received about costs and fees. Trustees cannot be certain whether any mandate that they are selecting genuinely offers value for money, or have confidence that the investment will perform in the way in which they expect – i.e. whether the expected returns will be lower as a result of costs and fees that are opaque.

Explicit and implicit costs

The information set that most trustees receive reports the explicit costs of fund management such as the Total Expense Ratio (TER) but in most cases fails to fully include all implicit elements in granular detail including custodian fees, exchange fees, bid-ask spread etc. This is not solely a reporting issue because there is evidence that fund managers themselves may not be aware of the trading costs of fund management.[22]

Among the high profile examples of hidden implicit costs example is the unbundling of research fees as the result of MiFID II. Historically, research costs were simply charged against client assets. With the new regulation, EU portfolio managers are required to either bear research costs directly from the firm's own resources, or, if they choose to charge clients for research, then they must adequately disclose and account to their clients for that expenditure[23]. In response, most asset managers have now chosen to bear research costs directly[24]. However, as these were historically charged against client assets, this was an income stream to the asset manager and by extension a hidden cost to the pension fund that reduced fund performance.

To highlight the impact of even modest differences implicit costs it is instructive to look at a research into defined contribution (DC) schemes which have fewer of the elements of defined benefit schemes that obfuscate costs – including the ongoing nature of a scheme and scheme solvency factors such as changes in life expectancy. In relation to a DC scheme, the Office of Fair Trading showed that a 1% per annum charge over 40 years will reduce the assets available for the purchase of an annuity by 21%.[25] This erosion is significant, and in the context of a DB scheme, would result in increased contributions from members and employers to make up any shortfall.

Taken together, the combination of opaque fee structures and the compounding effects of costs through time, mean that for relatively small changes in the cost of asset management, there can be a significant impact on the performance of a pension fund and its ability to pay pensions.

Cost transparency in the SLGPS

---

[21] See, APG Group, Performance Analysis of the LGPS; Deloitte, Pathfinder Report; and Mercer, Investment Structure Review, Scottish LGPS Scheme Advisory Board Working Group.

[22] Lane Clarke and Peacock, 2013, Investment management fees survey.

[23] https://www.pwc.com/gx/en/advisory-services/publications/assets/the-future-of-research-mifid-ii.pdf

[24] "The definitive list of asset managers that will pay for research", *Financial Times*, February 22, 2018.

[25] Defined contribution workplace pension market study, Office of Fair Trading, 2013.

This is not to ignore reforms in the reporting of investment management costs in the scheme which have been significantly improved by the Chartered Institute of Public Finance and Accountancy's (CIPFA's) new accounting standard and the LGPS Transparency Code. However, despite these improvements there are still likely to be significant costs that remain opaque and the extent to which consistency across funds has been achieved remains an open question.

The new CIPFA standard requires funds to report many more costs than under the old standard, which only required LGPS funds to report on invoiced fees. The impact of this most clearly seen in the West Midlands Pension Fund. Under the old standard of invoiced fees, WMPF reported £11.3m of costs in 2012/13, and £11.2m in 2013/14. However, after applying the new standard, its costs rose to £87.3m[26] and so much greater transparency was achieved.

But as the current CIPFA guidance requires the listing of management and performance fees together with transaction and custody costs this leads to at least two scenarios which could result in under reporting:

1. The LGPS fund has not asked for or received information on costs recovered from net return and is therefore only reporting on invoiced fees

2. The accounting standard requires the exclusion of indirect costs from the figures reported in the accounts

The new CIPFA guidance for 2019-20 will seek address these scenarios by requiring LGPS funds to state the extent of their use of the LGPS Code of Transparency in formulating their reported costs, and by enabling the inclusion of indirect costs in the report section of the document.

The SAB has adopted the Transparency Code developed by the LGPS in England and Wales for asset managers to sign up to. Originally, this was a template designed in conjunction with CIPFA, investment managers, and administering authorities[27] and required managers to send a full breakdown of implicit and explicit costs in a standardised format. But the code only applied to listed asset classes, and excluded alternative and other opaque investment structures.[28]

Looking at the Lothian Group submission, it suggests that under-reported SLGPS costs are c£70–80m per annum. In our view, this number is likely to be a conservative estimate of under-reporting. This is due to the lack of granularity in the data that is collected particularly in relation to alternative investments such a private equity or hedge funds. There are reasonable exposures to these assets in the SLGPS and they are expensive vehicles with complex and opaque fees, and this issue will more problematic if such investments are held within a fund-of-funds structure.

Closet indexation

---

[26] https://www.professionalpensions.com/professional-pensions/analysis/3010860/how-west-midlands-cut-costs-by-millions-of-pounds-through-transparency

[27] http://www.lgpsboard.org/images/CoT/Code_of_Transparency_20190306_v_1_5.pdf

[28] *Ibid*

Closet indexation by actively managed funds is an additional area where SLGPS funds may face hidden costs. Closet indexation occurs where a fund is marketed and priced as an actively managed fund but largely follows the benchmark index. This practice has been found to be widespread globally, and there is evidence that in the UK market, domestic equity funds specifically are closet indexers.[29]

Closet indexing undercuts the value proposition of active fund managers who justify their fees by their ability to generate superior returns and beat the benchmark index after all the costs and fees of fund management have been incurred. As active managers are more expensive than passive managers who aim to track the benchmark, albeit with some error, it is really a debate about high-cost versus low-cost investing.

Closet indexation is detrimental to investors, as the limited active positions in a closet indexing fund means that it is more likely to underperform after fees.[30] Consequently, the issue of closet indexation has caught the attention of the Financial Conduct Authority (FCA).[31] This again comes back to an issue of transparency around is being charged for asset management. For trustees such activities are opaque, as the fees being charged, and the underlying investment style being marketed, are simply not aligned. Moreover, in such a setting, trustees could have achieved the same outcome at a much lower cost.

Trustee knowledge and understanding

Another way to assess how much cost and fee transparency exists in the market is to examine how familiar trustees are with costs and fees. If cost transparency is common for both explicit and implicit costs and fees, then users of this information should be familiar with both. Recent evidence however has highlighted that trustees have a good understanding of the explicit costs of fund management such as Total Expense Ratio but are unfamiliar with many of the indirect and implicit costs.[32]

The research suggests that trustees of even large schemes were unfamiliar with the implicit costs of fund management. As Figure 1 below shows, trustees were not really aware of relatively common activities such as securities lending and common costs such as market impact. It is therefore not unreasonable to assume that many of these costs and fees are not transparent to trustees. Moreover, the analysis of trustees showed that the awareness of the implicit costs worsened as scheme size fell.

Figure 1: Trustee familiarity with fund management costs and fees[33]

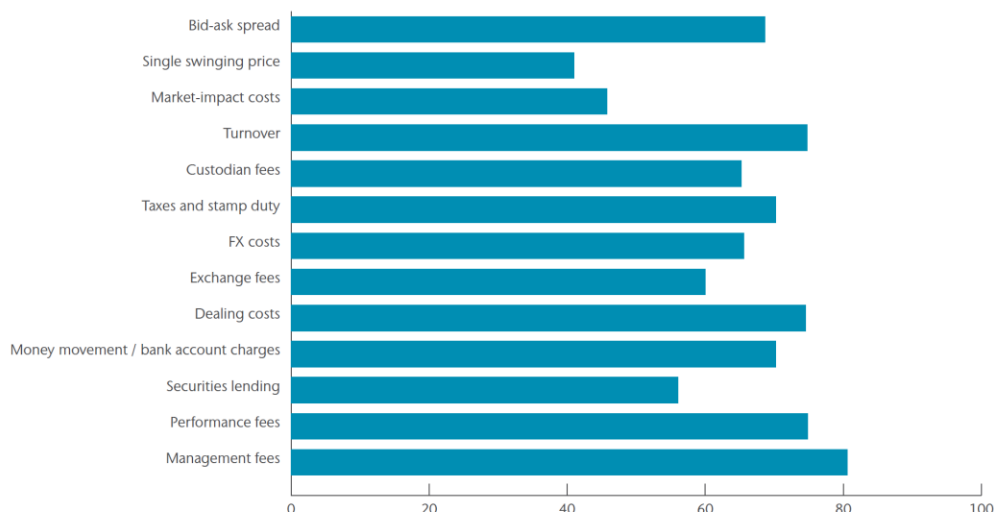
[29] Cremers, K. J. M. A. Martijn, P. M. Ferreira, and L. Starks. Indexing and Active Fund Management: International Evidence, Journal of Financial Economics Vol. 120, 3, 539-560, 2016.

[30] Petajisto, A. Active Share and Mutual Fund Performance, Financial Analysts Journal Vol. 69, 4, 73-93, 2013.

[31] https://www.fca.org.uk/firms/authorised-and-recognised-funds/closet-trackers

[32] Costs, Fees and Trustee Decision-Making, Aon Hewitt, 2017.

[33] Source: Figure 7a, Costs, Fees and Trustee Decision-Making, Aon Hewitt, 2017.



The Asset Management Market Review

In November 2015, the FCA commenced the Asset Management Market Review. This investigation into competition in the asset management industry included both retail and institutional investment sectors and concluded that the sector is not competitive; there is weak price competition; there is a lack of transparency and consistency around the costs and fees that are disclosed and charged; and the performance both active and passive funds, after taking costs and fees into account, underperformed.

For institutional investment, the interim report found evidence that of weak price competition in several areas.[34] There is low competition in active equity investments and firms in this sector do not compete on price.[35] For institutional investors, the prices of segregated mandates tend to fall as the size of the mandate increases so larger funds incur relatively lower costs.

The findings of the report showed substantial variation in performance. This variation was both across asset classes and within a specific asset class. Further, for both retail and institutional investors, on average, both actively managed and passively managed funds did not outperform their benchmarks after the costs of management.

Finally, in the proposed remedies for institutional investors, there was a recommendation that there was a need for a standardised template of costs and fees. While the report acknowledged that there were templates in existence such as the IA Code or the LGPS Transparency Code, these were not aligned, and that other work such as that of the Transparency Taskforce showed that there was a much greater detail on costs that could be realised. To achieve greater detail and standardisation, a group from across the industry as well as wider stakeholders, with an independent chairperson, was to be convened. The aim of the group was to create consistent and standardised disclosures of costs and charges that are borne by institutional investors.

---

[34] https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf

[35] In the conclusions of the FCA, this lack of competition around price was most acute in retail funds. However, this does not imply there is adequate competition in the institutional market, as this was an area of significant concern, as exemplified by the recommendation to establish what became the Institutional Disclosure Working Group.

The Institutional Disclosure Working Group

In addressing one of its key recommendations, the FCA convened the Institutional Disclosure Working Group (IDWG). The terms of reference for the group was to gain agreement on cost and fee disclosure templates for asset management services provided to institutional investors.[36] As well as representatives from asset management firms, the Group included academics, investment consultants, and other intermediaries. There were also representatives from the Department for Work and Pensions, the Organisation for Economic Co-Operation and Development, the Trades Union Congress, and the CFA Institute, all of whom were independent observers. As well as the independent chair, Chris Sier, one of the deputy chairs was Jeff Houston of the Local Government Association.

The remit of the group was not just to look at equities but to also fixed income, and alternatives such as private equity, property, etc. and arrive at a standardized cost disclosure template.

The final recommendations of the group were an agreed standardised account-level template covering most product types. This captures data from providers for standard assets such as equities and bonds in one place. In addition, there are three other templates for, private equity, physical assets such as property, and custody. This data is aggregated into a user template that summarises data from an account-level template. Institutional investors can therefore easily see key data from their providers, as well as easily segment data along dimensions such as asset class or manager[37]. The FCA welcomed the findings of the Group and has implemented its recommendations.

Costs and fees post-IDWG

The recommendations of the IDWG are now being implemented. Two key recommendations are first, that a new group to curate and evolve the disclosure templates should be created and second, there should be no regulation at this point that compels disclosure, rather a market-based solution should emerge if possible.

In September 2018, in conjunction with the Pension and Lifetime Savings Association, the Cost Transparency Initiative commenced, and this group will conduct testing and curate the templates going forward.[38] In February 2018, the Advisory Board to the LGPS in England and Wales agreed that it would adopt the IDWG templates and replace the templates that were being used as part of the LGPS Advisory Board's voluntary Code of Transparency.[39]

The rationale for this switch is consistency in reporting across institutional investment including the LGPS. It will lead to greater cost disclosure for alternative asset classes that previously could not satisfy the LGPS Advisory Board's voluntary Code of Transparency and were therefore excluded. It will also provide the ability to drill down into the detail of the account templates to understand costs and fees at a granular level if needed. Consequently, asset managers that had signed up to the original code will transition to the new disclosure

---

[36] https://www.fca.org.uk/publication/minutes/idwg-terms-of-reference.pdf

[37] https://www.fca.org.uk/publication/documents/summary-idwg-recommendations.pdf

[38] https://www.plsa.co.uk/Policy-and-Research-Investment-Cost-Transparency-Initiative

[39] http://www.room151.co.uk/blogs/jeff-houston-lgps-and-investment-cost-transparency/

template and all new signatories will have to follow the IDWG templates, thereby achieving greater fee transparency in the LGPS.[40]

Key Issue: Competition in investment management for LGPS funds

To what degree do LGPS funds benefit from competition for institutional investment management?

The Pensions Institute's review of material relating competition in the UK asset management sector suggests it is not a fully competitive market neither in its retail nor institutional segments. As such the SLGPS cannot place a high degree of reliance on price competition to help control investment costs in the scheme.

FCA evidence

One of the main sources of evidence relating to competition in the asset management market in the UK is the Asset Management Market Study of the Financial Conduct Authority (FCA).[41] This is a competition investigation in the same way as the Competition and Markets Authority investigates competition in other industries. The fact that an investigation occurred, at a very basic level, suggests there are significant concerns about competition.

The conclusions of the Asset Management Market Study were wide-ranging and covered both retail and institutional investment. Below is a verbatim statement from the study in relation to price competition in asset management:

"*We **find weak price competition in a number of areas of the asset management industry.** Firms do not typically compete on price, particularly for retail active asset management services. We carried out additional work on the pricing of segregated mandates which are typically sold to larger institutional investors. This showed that prices tend to fall as the size of the mandate increases. These lower prices do not seem to be available for equivalently sized retail funds*." [42]

Some submissions to the SLGPS consultation have interpreted this finding to suggest that there is a good level of competition in institutional investment, and specifically in the scheme, as the funds of the SLGPS can be considered large funds. However, what this statement says is that asset managers do not typically compete on price, and where this is most acute, is in actively managed retail funds. This statement does not say is there is no issue of price competition in institutional investment.

The FCA's study raises several different issues regarding institutional investment, and it is worth noting that pension funds were the major focus of the institutional segment of the study.

1. It suggests there is weak price competition in UK asset management as a whole, including the institutional investment sector.
2. It also says that prices for segregated mandates fall as mandate size increases, and so larger funds get better pricing. Analysis in this paper suggests that if the SLGPS

---

[40] *Ibid.*

[41] https://www.fca.org.uk/publications/market-studies/asset-management-market-study

[42] Final Report of the Asset Management Market Study, p. 4. Bold highlight is in the original text and repeated here for consistency.

were to pool assets, it would be a large fund, but even this pooled fund would not come close to the largest funds in the UK or globally.[43] Moreover, in the context of the SLGPS, most of the assets under management are in the Lothian and Strathclyde funds, and so the other 9 funds are arguably relatively small. Across the SLGPS, many of the smaller funds may not therefore be achieving the benefits that accrue to the larger funds.The statement applies to segregated mandates so it is therefore an open question across the SLGPS as to the extent that competitive pricing exists, as this will in part depend on what proportion of SLGPS assets are in segregated vehicles and what proportion are in pooled vehicles.

3. The submission of the Lothian Group suggests that more than 70% of the scheme's assets are managed by 10 asset managers while under 50% are managed by two asset managers. While this is not an indication of a lack of competition per se, it is a fact that needs some careful consideration and justification in the context of the overall SLGPS.

4. In the FCA study, the average profit of the asset management industry was 36%. Moreover, the submission from the Lothian Group estimated an average profit margins for four listed asset managers in the top 10 SLGPS external managers of approximately 46%, which equates to somewhere between £60–95m in profits paid to the asset management industry by the SLGPS.

Competitive pricing and competitive markets

In economics, standard theory predicts that where supply and demand meet then an equilibrium price is achieved, and that if there are shifts in prices, then the quantity demanded of a specific good or service changes in response. However, there is evidence that this transparent and competitive pricing does not exist in all markets, and so in some markets, the equilibrium price is 'shrouded'. Gabaix and Laibson (2006) argue that indirect costs, such as add-on prices can be 'shrouded' in markets where consumers do not anticipate the total cost when purchasing the primary product[44]. The consequence of this is that rather than supply and demand clearing at an equilibrium price, there is an excess demand i.e. too much of a good or service is consumed.

In addition, there is widespread evidence that buyers in certain markets systematically misunderstand product features e.g. add-ons, and this allows firms to charge high prices once they have an established relationship with the consumer (DellaVigna and Malmendier 2004).[45] Moreover, these unanticipated higher prices can persist even in settings where competition in the market is high. The consequence of this is that regulatory intervention may be required to improve consumer outcomes.[46]

In looking at competition in asset management in the UK, one of the key recommendations to address weak price competition on the institutional side was the need for there to be standardised granular cost and fee data. To this end, the FCA set up the Institutional Disclosure Working Group.[47] Given growing the evidence on the opaque pricing of asset

---

[43] See section *Key Issue: Scale benefits and the SLGPS*

[44] Gabaix, X., & Laibson, D. (2006). Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets. Quarterly Journal of Economics, 121 (2), 505-540.

[45] DellaVigna, S., & Malmendier, U. (2004). Contract Design and Self-Control: Theory and Evidence. Quarterly Journal of Economics, 119 (2), 353-402.

[46] Heidhues, P., Köszegi, B., & Murooka, T. (2012). Deception and Consumer Protection in Competitive Markets. Konkurrensverket.

[47] See section *Key Issue: Scale benefits and the SLGPS* for more detail.

management, and the need for better and more consistent fee disclosure, the consumption of the asset management industry by pension funds is one where there may well be excess demand for the services provided, as the ‘true’ cost of asset management is shrouded.

Investment consultants and trustee decision-making

One important aspect of the environment in which trustees operate is their use of investment consultants. Investment consultants have been integral to the trustee decision-making process since the Myners Report (2001)[48] and were a specific area of focus in the Asset Management Market Study.

Investment consultants are a key intermediary in supporting trustee decision-making and are often integral to manager selection through providing ratings for specific managers. In looking at the findings of the Asset Management Market Study, investment consultants’ advice on asset allocation and investment strategy was found to be significantly more influential in terms of outcomes than the advice on manager selection. That said, many institutional investors were found to struggle with monitoring and performance assessment in relation to the advice received.

The evidence from the Asset Management Market Study also showed that while asset management fees were considered as part of investment consultant ratings, this was typically not a major component of the overall ranking a fund manager received. Moreover, the final report the of FCA concluded that it was clear that different investment consulting firms placed a differential emphasis on fees in the rating process.

As well as an inconsistent emphasis on fees, investment consultants were not able to identify managers that offer better returns to investors[49]. In looking at consultant recommendations, Jenkinson et al (2017) show that funds that are on investment consultant buy-lists underperform.[50] This is due to the increase in fund flows from being on the buy-list and the inevitable diseconomies of scale[51] that occur in mutual funds. Overall, given the complex relationship between trustees and investment consultants, it is not clear to what extent there is price competition in asset management through this route, nor what performance is likely to accrue to pension funds in such a setting.

Long-termism in markets

The final issue with respect to competition in the asset management industry is to examine the impact of short-termism. As the Kay Review sets out clearly:[52]

“*Competition between asset managers to outperform each other by anticipating the changing whims of market sentiment – Keynes’ beauty contest – can add nothing, in aggregate, to the value of companies (just as the contest Keynes describes does not make any of the faces portrayed more beautiful) – and hence nothing to the overall returns to savers.*”

---

[48] Myners Review: Institutional Investment in the UK (2001)

[49] However, the manager selection process ensures that asset managers meet minimum quality standards and reduces operational risk for investors.

[50] Jenkinson, T., Jones, H., and Martinez, J.V., 'Picking Winners? Investment Consultants' Recommendations of Fund Managers' in Journal of Finance, 71(5) (2017), 2333-370

[51] See section *Key Issue: Scale benefits and the SLGPS* for more detail.

[52] The Kay review of UK equity markets and long-term decision making, Final Report, July 2012.

The conclusion of this statement is twofold. First, that competition between asset managers is competition to gain "alpha" – building an investment portfolio that offers superior returns to a comparable benchmark – and in aggregate this is a zero-sum game where the presence of investors who earn superior returns mean there must be investors who earn inferior returns. This is particularly true over the long-run i.e. in pension funds. Second, in such a setting, a true understanding of the cost of asset management is essential, as small changes in the cost of investment will significantly change investment performance outcomes.

In looking at the incentives in asset management, the Kay Review concludes that:

"The appointment and monitoring of active asset managers is too often based on short-term relative performance. The shorter the timescale for judging asset manager performance, and the slower market prices are to respond to changes in the fundamental value of the company's securities, the greater the incentive for the asset manager to focus on the behaviour of other market participants rather than on understanding the underlying value of the business."[53]

Overall, the investment management industry for pension fund investment has misaligned incentives and is a market where competition is arguably not based on ability in the long run, but short-run relative performance.

[53] *Ibid.*

Key Issue: Scale benefits and the SLGPS
How reasonable is it to expect scale benefits for SLGPS funds?

Based on our review the Pensions Institute believes that it is reasonable to expect that larger SLGPS funds benefit from economies of scale in the cost of investing. In the UK, larger funds are likely to have greater buying power and command lower costs and internationally, large pension funds tend to have both lower costs and generate higher returns. Although pension funds can become subject to diseconomies of scale, SLGPS funds in aggregate are small on an internationals scale, and are therefore unlikely to reach the threshold where these dis-benefits would apply.

There is a limited body of research that looks at LGPS funds in the UK and using this evidence alone has made it difficult to draw firm conclusions on the degree to which SLGPS could expect to benefit from scale in the management of investment costs. Existing studies can be used to argue for or against scale benefits as responses to the consultation note. Therefore this review includes international evidence relating to scale in pensions funds.

Economies and diseconomies of scale

Economies of scale is a foundational concept in economics, and it applies across a range of businesses and contexts, including in pension funds and asset management. Economies of scale benefits include operational efficiency, so the cost per unit of production is cheaper; buying power to negotiate lower costs on inputs; specialization so that expertise is developed or hired in specific areas; and improved risk-bearing. That said, there are limits to economies of scale, and so if a business or organization becomes too large, then these benefits start to decrease. For example, the cost per unit of production starts to increase as operational efficiency declines.

In the context of pension funds, it is useful to illustrate how diseconomies of scale can occur. This is a slightly more nuanced exercise than the traditional examination of the diseconomies of scale in a firm where inefficiencies occur due to issues of control and informational asymmetry. In the traditional firm, scale can, for example, decrease performance through increasing the costs associated with using soft information inside larger hierarchies.[54]

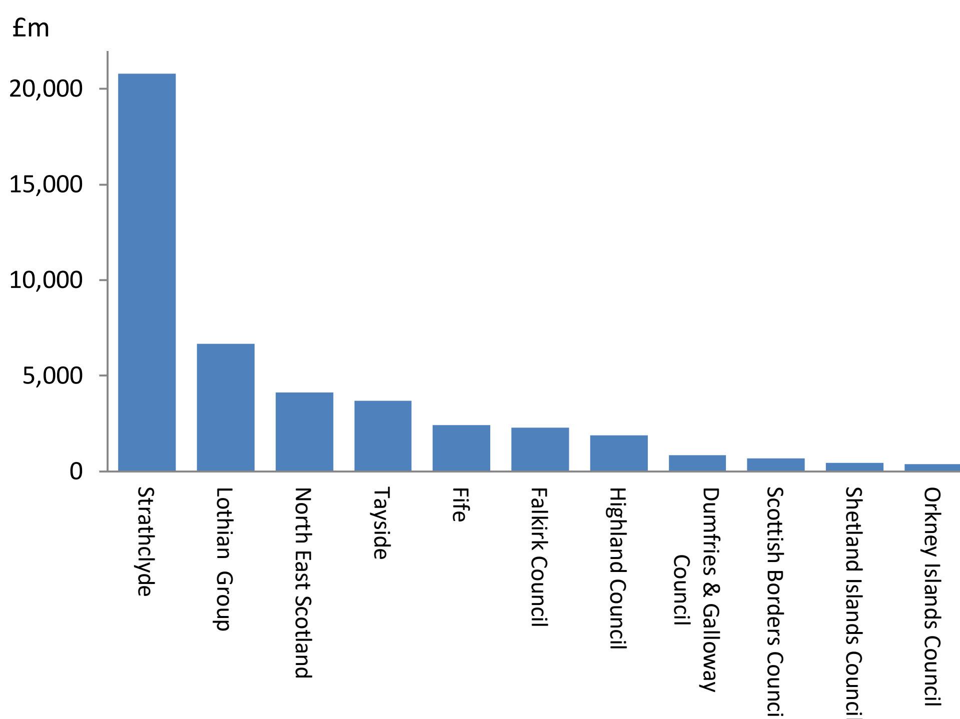
For pension funds, and this is true of the SLGPS, a significant amount of asset management is outsourced. The natural starting point to understand where diseconomies can occur is to examine diseconomies in the mutual fund literature,[55] and evidence of diminishing returns to scale in mutual funds has been found in numerous studies.[56] Part of this reduction in returns is because fund inflows simply scale up the current investment strategy of the fund rather than leading to other investment strategies.[57] Another aspect of the diseconomies effect is driven by market impacts driven by larger transaction sizes.[58]

The first question that must be asked, is therefore, what is large in pension fund terms? If total SLGPS assets were to exceed this then it could be argued that diseconomies of scale could occur.

---

[54] Stein, J. C., (2002), Information Production and Capital Allocation: Decentralized versus Hierarchical Firms, Journal of Finance, Volume 57, No. 5, 1891-1921.
[55] Dyck, A. L. and Pomorski, (2011), Is Bigger Better? Size and Performance in Pension Plan Management, Rotman School of Management Working Paper No. 1690724
[56] Chen, J. S., G. Harrison, M-H. Hong, and J. D. Kubik, (2004), Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization, American Economic Review, Volume 95, No. 5, 1276-1302.
[57] Pollet, J. M. and M. Wilson, (2008), How Does Size Affect Mutual Fund Behaviour? Journal of Finance, Volume 63, No. 6, 2941-2969.
[58] Edelen, R. M., R. Evans, and G.B. Kadlec, (2007), Scale Effects in Mutual Fund Performance: The Role of Trading Costs, Working Paper, University of California, Davis.

Figure 1: Scottish LGPS funds by assets under management, 31 March 2018[59]



The SLGPS is composed of 11 individual funds with assets totalling around £42bn and liabilities to members of £55bn.[60] Each fund serves a different group of employer organisations, the largest fund is Strathclyde with £19.7bn in assets and 210,000 members; Orkney Islands is the smallest, with assets of £335m and 3,663 members.[61] Figure 1 above shows a bar chart of the 11 funds by assets under management (AUM). Below, Figure 2 shows the top 10 pension funds globally by assets under management for the year ending 2016.

Figure 2 Top 10 global pension funds end 2016 by assets under management[62]

Rank	Name	Country	AUM US$ m
1	Government Pension Investment	Japan	$1,237,636
2	Government Pension Fund	Norway	$893,088
3	Federal Retirement Thrift	U.S.	$485,575
4	National Pension South	Korea	$462,161
5	ABP	Netherlands	$404,310
6	National Social Security	China	$348,662
7	California Public Employees	U.S.	$306,633
8	Canada Pension	Canada	$235,790

[59] Source: Audit Scotland; fund annual reports

[60] The SLGPS also includes five additional funds including transport funds and the Scottish Homes Pension Fund which are managed by the 11 administering authorities

[61] All figures dated 31 March 2017

[62] Source: Pensions & Investments / Willis Towers Watson 300 analysis

9	Central Provident Fund	Singapore	$227,102
10	PFZW	Netherlands	$196,461

What is very clear from comparing Figure 1 and Figure 2, is that the SLGPS even when pooled would be orders of magnitude smaller than the largest funds globally. Moreover, in the same survey, The BT Pension Scheme and the Universities Superannuation Scheme (USS) only rank 56 and 59 respectively. Consequently, if the SLPGS were to pool it would still be significantly smaller than either the BT pension fund (£49.1bn)[63] and USS (£63bn). Overall, the pooling of the SLGPS is not of a scale where diseconomies of scale are likely to occur, and so it is reasonable to assume that there are scale benefits that would accrue.

Additional evidence on the source of the returns to scale can show that the largest pension funds outperform smaller funds by 45-50 basis points per annum on a risk-adjusted basis. Moreover, between one-third and one-half of these gains arise from cost savings that are attributable to internal management, where costs are, on average, at least three times lower than under external management.[64]

Scale in pension funds and the costs of investment

There are several ways of examining the issue of examine if the costs of asset management and administration are subject to the benefits of scale and larger funds are cheaper to run.

UK evidence suggests that larger funds have better able to procure outsourced – external – asset management on favourable terms. The Asset Management Market Review of the Financial Conduct Authority (FCA)[65] examined the level of competition within both the retail and institutional investment sectors. One key insight in relation to scale is that, "*On the institutional side, there are a large number of small pension schemes and trustees which vary in how effective they are at negotiating price.*"[66] In the UK, larger pension funds are therefore, on average, better able to drive cost efficiencies in the procurement of outsourced asset management services.

International studies of pension funds show that larger funds tend to have lower costs. One example is the Swedish Premier Pension System. The strategic plan for the scheme is to reduce total costs over a thirty-year period from 0.71% to 0.17%. As Table 1 below shows, there are cost savings in both administration and in the costs of asset management from 0.71% to 0.33% in 2017.

Table 1: Costs in the Swedish Premier Pension System (percentage points)[67]

	2002	2005	2008	2011	2014	2017	2020	Target
Administration costs (% AUM)	0.30	0.23	0.18	0.15	0.12	0.08	0.04	0.05
Fund management costs (% AUM)	0.41	0.36	0.32	0.29	0.27	0.25	0.24	0.12

[63] Source: BT 2018 Annual Report
[64] Dyck, A. L. and Pomorski, (2011), Is Bigger Better? Size and Performance in Pension Plan Management, Rotman School of Management Working Paper No. 1690724
[65] https://www.fca.org.uk/publications/market-studies/asset-management-market-study
[66] https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf
[67] Source: Sweden's New Pension System, Swedish National Social Insurance Board

Total fund costs (% AUM)	0.71	0.59	0.50	0.44	0.39	0.33	0.28	0.17

One aspect of being able to achieve cost efficiencies comes from the ability to perform asset management in-house, rather than using outsourced asset management. The is plentiful evidence that outsourced services in the public service sector are more expensive; the Private Finance Initiative programme provides leading examples.[68]

Regarding in-house against outsourced asset management, comparing the SLGPS to the University Superannuation Scheme (USS), the investment fees of USS are 34% lower (0.31% of investments, compared to 0.47% for the SLGPS)[69].This cost differential is largely attributable to the fact that c75% of USS assets are managed internally (vs c10% for SLGPS). If the SLGPS could achieve the USS expense ratio of 0.31%, then fee savings could be £65m per annum assuming the current cost disclosure mechanisms of the SLGPS are capturing the 'true' cost of asset management. It is also worth noting that more expensive investments are typically illiquid, so savings from these allocations could take time to materialise. However, a 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 the SLGPS liquid assets alone.

As well as the discussions around the cost of in-house vs outsourced asset management, there is a question of incentives. In the original evidence provided to the consultation on scale in pension funds, the case of the Ontario Municipal Employers Retirement Scheme (OMERS) was presented. The structure of OMERS is the result of a strategy to build in-house teams across all activities of the fund, including both public and private investments. In-house teams, therefore, originate, execute, and directly manage most scheme assets on behalf of members. This enables coordination across investment platforms to manage costs. More importantly, this give absolute clarity to the investment objectives of the fund, as these in-house teams are focussed solely on the delivery of the long-run objective of the fund i.e. to pay pensions.

One final area of disagreement is whether the pooling of the LGPS in England and Wales is delivering cost efficiencies. As with debates on various analyses that have been undertaken for the SLGPS[70] the initial evidence from the LGPS pools in England and Wales provides some insight but needs careful consideration as it is presented at a point in time when funds have not fully pooled and others have only recently been authorised by the FCA.[71] A recent study[72] found ACCESS, who has already contractually pooled circa £11bn of passive assets under a single commercial relationship with UBS, is expected to generate £5m cost savings per annum. The Local Pensions Partnership has generated £7.5m per annum in fee savings for global equities alone.[73]

[68] https://www.theguardian.com/public-leaders-network/blog/2012/apr/11/public-private-partnerships-the-record-isnt-great

[69] The USS expense ratio of 0.31% is based on independent third-party benchmarks and not the accounts of the fund.

[70] See discussions on the analysis to the APB, Deloitte and Mercer papers in the submissions to the consultation.

[71] For example, the Brunel Pension Partnership only received FCA authorisation as a MiFID full-scope investment firm in March 2018.

[72] https://www.professionalpensions.com/professional-pensions/feature/3029061/where-are-the-lgps-pools-three-years-on

[73] The Local Pensions Partnership has already saved more than set out in its business plan as the initial estimate was £30m net savings in investment management fees over five years.

Governance and democratic accountability

Two further issues that are raised with respect to pooling or merging are the loss of local accountability and the ability of funds to engage with issues that are locally important e.g. Environment, Social, and Governance (ESG) issues.

For the first, whether local accountability is possible, this simply down to whether the governance structure chosen enables this. There are many examples of governance structures that allow for democratic accountability in scheme governance over much more diverse populations and regions. One notable international example is the CERN pension fund in Geneva. Here there is an executive board that run the scheme, but given the international nature of CERN, there is a supervisory board that has representation for employees, as well as sponsoring member states to ensure that the running of the scheme and its costs has democratic accountability[74].

The second issue of ESG and holding firms to account is more challenging. In the submissions to the consultation there is a sense that ownership and voting are directly linked in the current structures. However, the reality of ownership in the UK is one that is opaque, and the link between issuers and asset owners is one that often does not allow for voting to take place in a direct way. Ownership is usually through a complex chain of intermediaries such as custodian banks, proxy voting agents, and fund managers, with no visibility given to asset owners.[75] For larger pension funds there are fewer structural barriers to exercising shareholder rights. However, the barriers that exist for smaller funds are considerable as not all investment managers allow for split voting in pooled funds and dissuade smaller funds from exercising "voice".[76] The proportion of outsourced investment management and the number of smaller, funds in the SLPGS means that the level of influence on investee firms is unlikely to exist in the way in which most trustees expect.

[74] http://pensionfund.cern.ch/en/social-security-for-personnel/organisation-of-the-fund/composition-of-the-governing-board
[75] See for example, Exploring the Intermediated Shareholding Model, the Department of Business Innovation and Skills (2016).
[76] *Ibid*