

LOCAL GOVERNMENT PENSION SCHEME SCOTLAND

SCHEME ADVISORY BOARD MEETING

24th November 2021

LGPS SCOTLAND STRUCTURE REVIEW:

EXISTING EVIDENCE REVIEW & GAP ANALYSIS PROCESS

1. Summary

A review of evidence, drawn from the existing body of work on the Scottish LGPS pension scheme structure, has been assessed by a small focus group. Membership of the group consisted of representation from SLGPS funds, employers, and two external independent experts. The aim was to agree a baseline of evidence, to provide a foundation for developing the four business cases required of this project, as well as identify evidence gaps where further work is required.

There was a significant level of consensus and agreement on the current validity and relevance of the evidence sources and which material should be used to form part of the ongoing evidence baseline.

The gap analysis to identify evidence still required to complete the business cases, is not yet finished, although there has been a very good level of progress. The group also now has a comprehensive data source of all data held by funds and how this data is held.

Work is continuing to complete the gap analysis and clarify ongoing work and resource needs for the project.

2. Actions Requested/Recommendations

The SAB is asked to note the conclusions of the Focus Group on the evidence baseline and to give its agreement to the gap analysis work progressing on this basis.

The SAB is asked to agree to a special meeting (if this should prove necessary) to consider the gap analysis findings. This will also outline the ongoing work required, potential resource implications and indicative costings, for taking the project forward. This meeting is likely to be required very early in 2022.

3. Background & Context:

The work to undertake a review of existing evidence, previously commissioned by or produced for the SAB, was signed-off to proceed by the project's Sub-Group on 2nd September 2021. The aim was to establish and agree a baseline of verifiable and relevant evidence for the project to build on (and thereby avoid any duplication of cost and effort redoing the same work).

The evidence sources to be reviewed were primarily those referenced on the SAB's own project Work Specification. A full list of evidence sources is provided in Appendix 1.

A short-life focus group was set up to undertake this work. Membership included representation from Strathclyde, Lothian and Tayside Pension Funds, multi-fund employers Police Scotland and Scottish Water and two external independent experts (an investment management consultant and a senior academic), to provide additional input and perspective. The group was chaired by Brian Strathie, the Project Sponsor. Membership of the Focus Group is provided in Appendix 2 of this paper.

4. Assessing the Evidence:

It was confirmed with the group that this review was a 'quality assurance' assessment, rather than the extent to which group members agreed or disagreed with the findings and conclusions of each source.

The key work areas outlined in the SAB's project Work Specification (Appendix 3) was used as a framework to provide structure and focus. An additional heading for 'Funding' was added.

Because the evidence covers a wide range of themes and areas, it was recommended that the assessment approach should seek to avoid overly complex or 'over engineering' the 'scoring'. Based on this the following criteria were agreed:

- 1. Good** – evidence is robust, rigorous, and thorough, sufficiently current or easily updated. Only minor amendments/modifications required.
- 2. Moderate** – evidence gives good grounding/starting point, but needs more work or significant updating (e.g. breadth/depth, context, sufficiency of data/analysis etc.)
- 3. Deficient** – evidence lacks sufficient relevance/rigor/reliability – needs significant work to improve/update it. Redoing work may be a better option
- 4. Gap** – evidence not included – or only covered superficially. Needs to be obtained/commissioned.

The group initially undertook the review individually, then shared and discussed this at a series of meetings, to reach an agreed position.

5. Review of Existing Evidence & Gap Analysis

5.1 Review of the Evidence Materials:

There was a high level of consensus across the group on what evidence was sufficiently rigorous and reliable to constitute part of the ongoing evidence baseline.

The various evidence sources were fully discussed:

Exclusion from Baseline:

There was agreement that several pieces are: too out of date to be sufficiently useful or relevant; were too narrow in focus or too short a period of time was analyzed; that evidence had been superseded and/or well referenced in subsequent work.

For these reasons, it was agreed the following sources should be **excluded** from the ongoing review. These are:

- Audit Scotland – Public Sector Pensions Costs – out of date & superseded by other evidence
- Audit Scotland – 2018/19 Supplement – out of date and lacks sufficient detail
- APG Comparison with Deloitte – data used and analysis done (for both reports) is now 10+ years out of date and investment strategies across funds have changed - neither data set provides a sufficiently strong or relevant data base to use. The APG/Deloitte comparison is also adequately referenced and contextualized by Pension Institute reports
- FCA Asset Management Marketing Study – predominantly retail industry focused and relevant conclusions well covered by the Pensions Institute. The recommendations are also covered by the Cost Transparency project.
- Chris Sier Presentation – insufficient data/detail in the presentation - this area is also being progressed with the Cost Transparency template & project

Useful Reference Points:

Other evidence sources, whilst out of date, were thought to offer some relevant and useful perspective or analysis, it was agreed they could present useful reference points for informing further work.

These are:

- APG UK LGPS Analysis – out of date – data and analysis is 10+ years old (the data used dated from 2001-2009) and fund asset mixes have changed over time. However, the report provides useful breadth of analysis and insight into a ‘wider universe’ of UK LGPS fund data (it includes 100+ funds). It was thought that some of this could be refreshed/replicated.
- Deloitte Pathfinder II – out of date - data and analysis is 10+ years old – and, as above, asset mixes have changed, so there is an insufficiently sound base to build on. However, the report is comprehensive and includes analysis on structures and costs for other areas that are not covered to the same level of detail (or at all) elsewhere. This includes work on pensions administration structures and costs, ICT costs etc. which could usefully and more easily be refreshed. It also offers analysis and insight on areas such as governance structures and asset allocation, not covered to the same extent elsewhere, that can also be refreshed.

It was agreed that some of these areas would be useful to update and that the time series should be extended to 10 years of data.

Primary Evidence Sources:

Three primary sources of evidence were agreed as providing the most relevant and rigorous evidence. These are:

- SAB Working Group Report & Annexes – It was agreed that this represents a good exploration and initial positioning of the key questions to be addressed, clarifying options, and detailing some of the pros/cons of each well.

The ‘All Funds Accounts’ and ‘Funds by Mandate’ data, compiled from fund data by the Working Group for the Mercer report, provide a very good starting point for data analysis. It was agreed these should be updated and the time series extended from 5 to 10 years.

Working Group Report Annexes - External Reports:

Mercer: whilst the data sample was limited (5 years) and the report's initial analysis viewed as weak, it was agreed the report surfaces a range of important questions and issues which continue to be relevant to this project (ESG implications on investment strategy, governance, skills and expertise for decision making etc.).

Prof. Clacher's paper 'Understanding Scale': it was agreed Sections 2 & 3 provide a useful exploration on the benefits of scale, the international research informing this and some insightful case studies. It was noted that some of the assertions on merger and pooling appear to be based on assumptions of what structures would prevail and that these would need to be evidenced.

- The Pension Institute Reports – it was agreed that this provides a useful and comprehensive synopsis of all prior evidence, as well as referencing more recent developments and research (up to 2018). The reports clearly summarize and articulate the arguments for/against and the pros and cons of each option. There was consensus on the overall quality of discussion and analysis, based on information available (e.g., pooling was still at a nascent stage). It was agreed that this series of reports provide a sound starting point for more detailed analysis.

The summary of key arguments/themes from the stakeholder consultation (and the actual consultation responses) represents extremely valuable insight into the various stakeholder views and positions.

- KPMG Governance Report – this was generally accepted as useful and relevant on Board composition and responsibilities, but that it lacked analysis and could be extended further.

5.2 Key Points to Emerge from the Evidence Review

One of the primary observations to emerge was the lack of quantitative data and analysis within most of the evidence sources. It was agreed that more substantial work would be required to illustrate/verify each business case.

Where data is presented, it tends to cover a short time series (usually 5 years) which limits the extent to which it can be meaningfully extrapolated. An extended analysis of fund data over a 10 year time series is thought to be more illustrative and informative for the business cases.

Much of this data is already available from the funds (annual accounts, triennial valuation reports etc.)

The group also agreed that it was very important to establish a clear and thorough understanding of the existing scheme structure and how it currently operates across all funds. This would identify strengths and weaknesses, as well as provide additional insights on potential alternative options.

Appendix 4 provides more detail on the outputs of discussion from the evidence review, against each of the SAB Work Specification areas.

6. Scottish LGPS Fund Data

Group members from the funds also produced comprehensive lists of all data produced/held by funds, against the SAB's Work Specification headings, including initial considerations for the data likely to be required for cost benefit analysis and how some of this data could be broken down further to provide more insight.

Work is ongoing to determine what data will be required from all funds and a data request list will be produced

7. Gap Analysis

Work on determining and clarifying the evidence gaps is still ongoing and it is hoped that this will be completed over the next few weeks.

However, there are two areas of work which were agreed as necessary to (1) help provide wider context and (2) provide critical analysis for all structure options, namely:

1. A macro-level analysis¹ of the wider environment in which the Scottish LGPS funds operate, identifying and exploring those factors that may influence and/or impact on how funds operate in future. This will build on and update previous analysis by the SAB Working Group.
2. Develop a model for a comprehensive cost benefit analysis for all structure options, using existing fund data, supplemented by other appropriate data, as necessary.

8. Resource implications

The Focus Group will continue to undertake the gap analysis work and to identify how best to utilise fund data to support the business cases.

The resource implications (resource levels as well as expertise/experience) for addressing the gaps and producing the business cases - and various options for doing so - will be considered by the group, and indicative likely costs estimated.

9. Next Steps

1. Complete the gap analysis, resource implications and indicative costs.
2. Present to SAB in early 2022. A special meeting of the SAB may be required to accommodate this.

Paper by: *Pat Tomlin, Strategic Programme Manager*

¹ A PESTLE analysis of wider, external factors: political, economic, social, technological & environmental factors

Appendix 1:

Evidence Sources Used for the Baseline Review

1. The Pensions Institute 'Consultation Final Report: **Review of the Structure of the Scottish Local Government Pension Fund** (3 sections) 2018.
A consultation of employers & employee representative groups on whether outcomes for members and sponsors of Scottish LGPS can be improved by changes to the scheme structure. This report provides a section on background context and data sources; Analysis of the responses to the consultations; and conclusions & key issues.

The Pensions Institute '**SAB Structure Review Consultation Responses**' all responses from employee and employers representative groups, pension funds, administering authorities and other stakeholders (2018)
2. SAB Working Group '**Review of the Structure of the Scottish LGPS**' (main report and annexes) 2016/17
The Working Group was set-up to undertake a review of the Scottish LGPS Scheme and provide an options appraisal. This included a research review on '**Understanding Scale in Pension Funds**', by Prof. Iain Clacher and an analysis of fund data for each of the 4 options, by Mercer, '**Investment Research – Structure Review**'.
3. Chris Sier '**Cost & Fee Transparency Presentation to LGPS**' (2018-19)
4. Audit Scotland '**Scottish LGPS Overview Supplement**' (2018/19)
5. Financial Conduct Authority '**Asset Management Marketing Study**' (2017)
Market study of competition and value in the Asset Management market in UK
6. KPMG '**Scottish Public Service Pensions Governance Review**' (2017)
Review of governance arrangements for the public pension boards and scheme advisory boards
7. APG '**APG & Deloitte Comparison**' (2011/12?)
An analysis of investment performance of both APG and Deloitte reports (below) commissioned by Unison
8. APG '**LGPS Performance Analysis**' (2011?)
Unison commissioned APG to analyse a dataset from 101 UK LGPS funds to assess investment performance over several years and if consolidation could lead to economies of scale
9. Deloitte '**Pathfinder II Report**' (2011)
Pathfinder project was initiated in 2007 to identify cost savings/efficiencies in Scottish local government through shared services. For Scottish LGPS the focus was on pension administration and investment management (not scheme design/benefits). The project scope was widened in 2008 to look at opportunities for rationalisation and improvement. Phase II focused on cost effective pension administration management and investment management model
10. Audit Scotland '**Cost of Public Pensions Sector in Scotland**' (2011)
Assessment of financial pressures on Scottish public pension schemes, outlining how schemes operate, how costs are controlled and governance structures. Part 4 of report focuses on Scottish LGPS.

Appendix 2:

Membership of the Evidence Review Focus Group

Chair: Brian Strathie - Scottish Water (SAB Member and Project Sponsor)

Sharon Dalli - Police Scotland

Tracey Russell – Tayside Pension Fund

Richard McIndoe/Jacqueline Gilles* – Strathclyde Pension Fund

Bruce Miller/Albert Chen* – Lothian Pension Fund

Aleksander Andonov – Senior Associate Professor, University of Amsterdam

Alistair Sutherland – Independent Investment Consultant

Pat Tomlin – Strategic Programme Manager

(*where there are two names for a fund, this ensured for attendance during holidays/other commitments etc).

Appendix 3

Extract from SAB Project Work Specification used for the Evidence Review

- **Cost of the Scheme**
 - Cost transparency
 - Human resources
 - ICT
 - Investment management (both Internal and External)
 - Pensions administration
 - Other costs

- **Return on investment**
 - Investment strategy/assumptions/costs
 - Risk appetite
 - Risk management
 - Complexity
 - Scale and capacity
 - Asset classes
 - Stewardship and responsible investment
 - Investment in Scottish infrastructure

- **Governance**
 - Conflicts of interest
 - Decision making
 - Oversight and accountability
 - Resilience and electoral cycles
 - Knowledge and understanding
 - Stakeholder representation
 - Budgets available to administer funds
 - Environmental, social and Corporate Governance

- **Operating Risks**
 - Human resources, including succession planning and training and development requirements
 - Specialist pensions and investment expertise and knowledge
 - Service quality implications of each of the four options for members and employers
 - ICT

Appendix 4

Evidence Baseline: Summary of Focus Group Views

SAB Work Specification Priority Headings	Evidence Baseline and Sources
<p>Cost of Scheme</p> <p>Cost transparency Investment Mgmt. (internal/external) HR ICT Pension Admin</p>	<p><u>Iain Clacher</u> – good overview of academic research & useful international/Lothian case studies on internal/external investment mgmt. teams and scale benefits (also informing on collaboration/ pooling/merger themes), but not substantiated by quantitative data/supporting evidence. Discussion on scheme costs/benefits of scale, but no quantitative data to substantiate or illustrate this</p> <p><u>Fund data produced for Mercer</u> – detailed data on fees and mandates provides a good basis for assessing all costs for the evidence requirements –this should be updated, with an extended time series and costs could be broken down further (e.g., HR, ICT etc.). The mandate data could also potentially be adapted to assess different structure options.</p> <p><u>Pension Institute</u> - good detail and discussion of context, coverage of other evidence sources (included in the evidence pack), as well as providing an update to 2018 (i.e. FCA investment market survey, additional academic research). Good quality discussion/coverage on cost transparency, HR (internal/external team, staff resources – esp. for smaller funds, key person risks/succession etc.). Little/no quantitative evidence to illustrate or substantiate.</p> <p><u>Deloitte</u> – good on pension administration analysis and options, key person risks/fund resilience. Data on staffing levels/roles & average costs, as against UK average is old and needs to be updated. Good discussion on options.: collaboration/shared services, merger and even outsourcing of administration Provides evidence on ICT costs - although old it can be updated. ‘Customer’ survey of administration service provision is old /out of date but provides useful insight and a good starting point. Investment costs – fee ‘survey’ of investment managers to augment data not provided by funds. Does cost transparency template data negate the need for this kind of approach across all asset classes now?</p> <p><u>APG</u> – possibly worth replicating data analysis of average relative administration expenses by size of fund. Data old and has a limited time series, also changes in where/how funds are investing since this was undertaken, so would need to be updated and time series extended.</p>

<p>R.o.I. Invest. Strategy – assumptions & costs</p> <p>Risk Appetite Risk Management Complexity Scale/Capacity Asset Classes</p> <p>ESG Infrastructure</p>	<p><u>Iain Clacher</u> – good discussion/examples of scale benefits & overview of related research. Good overview on complexity, asset classes & also infrastructure issues – but several statements/assertions in paper not well evidenced</p> <p><u>Mercer</u> – coverage of issues quite good and raises useful questions on complexity. Data on asset allocations, costs/returns good, but some of the analysis is weak (although there are caveats due to the limited time series of data).</p> <p><u>Fund data produced for Mercer</u> – good starting point on mandates & fees – needs to be updated & time series extended to 10 years</p> <p><u>SAB Working Group Options Paper</u> – report outlines available options and points to importance of scale. Good summary of wider/external challenges facing pension sector/the funds (Annex 5) and discussion on ESG and engagement. Good section on challenges of implementing any structure changes to pooling/merger. Report gives a useful baseline and needs to be updated/augmented.</p> <p><u>Pensions Institute</u> - good quality discussion/exploration on most areas and provides review of key reference/evidence points, although they primarily focus on cost savings. Outline of each option and potential implications are thorough, as is the analysis of pros & cons of each, although quantitative data is needed to illustrate/substantiate these points. Some discussion on infrastructure & ESG issues/implications, again not backed up with data (e.g. adoption of ESG policies across funds).</p> <p><u>Deloitte</u> – analysis of investment management costs as reported and as percentage of asset value for all 11 funds (tables 2.2 & 2.3) very useful – but data old & needs to be updated/time series extended (10 years). Analysis of asset allocation provides useful baseline and time series should be extended to the present.</p> <p><u>APG</u> – the breadth of sample (100+ UK LGPS funds) provides a useful wider perspective, but the analysis also needs more breadth and greater clarity on the factors that are driving the returns.</p>
<p>Governance</p> <p>Conflicts of interest Decision making Oversight & accountability Resilience & electoral cycles Knowledge & understanding Stakeholder representation</p>	<p><u>Iain Clacher</u> – good discussion on most governance areas and highlights implications/considerations on governance across all 4 options (although tendency to make assumptions about what future structures would be). Some good commentary on decision making, oversight/accountability and resolving potential conflicts of interest via a merger option.</p> <p><u>Mercer</u> – useful observations on engagement</p> <p><u>SAB Working Group Options Paper</u> – useful high-level summary of governance implications for funds, in face of external challenges (documented in Annex 5).</p> <p><u>Pensions Institute</u> – good coverage on most key areas of governance and highlights challenges of current structure. Good discussion on the various external agents/interests (consultants/investment managers) and potential influence, also on trustee/elected representative levels of</p>

<p>Budgets avail. To admin funds</p>	<p>knowledge/expertise and the challenges of electoral cycle and ‘churn’ of representatives on committees. Provides useful exploration of potential governance impacts/options from pooling/merger. Some useful discussion on budgets available to administer funds – not covered elsewhere Lacks quantitative data, but good overall coverage of key issues.</p> <p><u>KPMG Governance Report</u> - good on Board composition and responsibilities but lacks deeper analysis (e.g. relevant experience of elected reps to pension committees, criteria for election etc.). Could be extended to consider these issues.</p> <p><u>Deloitte</u> – coverage on decision making & oversight/accountability good - especially on widening employer & member representation. Details of governance structures across 11 funds and it would be useful to update this. Report also raises the question on the level of use of independent external specialist advice, compared with usage in private sector</p>
<p>Funding</p> <p>Predicted cashflow Employer Covenants Exit & Strategy Assumptions/ Valuations (different approaches)</p>	<p><u>SAB Working Group Options Paper</u> – useful context and background to funding issues, challenges, and considerations for each structure option. Need to check if these still current and whether this work needs to be extended further</p> <p><u>Pension Institute</u> – good discussion on all key points - although lacks quantitative data.</p> <p><u>Audit Scotland 2018/19 Supplement</u> - good on predicted cashflow and overview of funding status & discount rates, although data now outdated</p>
<p>Operating Risks</p> <p>HR/Succession/T&D Needs Specialist Expertise Service Quality Implications Employers & Members ICT</p>	<p><u>Iain Clacher</u> – some useful coverage on potential succession/resource pressures – especially for smaller funds</p> <p><u>Mercer</u> – good discussion on specialist skills requirements</p> <p><u>SAB Working Group Options Paper</u> – useful on challenges facing staff & resourcing pressures (Annex 5)</p> <p><u>Pension Institute</u> – good coverage on most of these areas, except ICT.</p> <p><u>KPMG</u> – good for Board composition & skills but lacks analysis</p> <p><u>Deloitte</u> – some coverage of succession/resourcing issues. Good on service quality and core/non-core service work – customer/service user survey. Comparison of ICT costs across funds good but needs to be updated.</p>