Call for evidence on the future structure of the Local Government Pension Scheme – Response on behalf of Merseyside Pension Scheme.

Merseyside Pension Fund provides the Local Government Pension Scheme for the Merseyside region, delivering pension administration, investments and accounting on behalf of the 5 Merseyside District Councils and over 130 other employers.

The Fund has over 123,000 scheme members and is responsible for the investment and accounting for a pension fund of £5.7 billion.

Over the years, the Fund has developed its collaborative working to include pensions administration services for the Fire-fighters' scheme, hosting the national 2014 Reform website on behalf of the LGA/trade unions and leading the joint procurement of actuarial services on behalf of neighbouring funds.

We have set up a joint initiative with Cheshire Pension Fund to work together on implementing the 2014 reforms with a view to standardising systems, policies and procedures. This will facilitate the development of future joint working arrangements.

The Fund believes that the great majority of efficiencies and cost savings sought will be realised through collaboration and joint working without the need for the formal merger of local government pension schemes.

I should be grateful if you would consider the following comments in relation to the call for evidence on the future structure of the Local Government Pension Scheme.

Question 1 – How can the Local Government Pension Scheme best achieve a high level of accountability to local taxpayers and other interested parties – including through the availability of transparent and comparable data on costs and income - while adapting to become more efficient and to promote stronger investment performance.

The current governance arrangements within the LGPS where Pensions Committees are principally comprised of locally elected councillors already provide a high level of accountability to local tax payers and interested parties. Governance compliance statements, prepared by LGPS funds, confirm that the great majority provide detailed information on performance and activities through annual reports and other publications. The governance changes proposed as a consequence of the Public Service Pensions Act 2013 will only strengthen this.

These governance arrangements ensure that, within the LGPS, there is a great deal of information publicly available. However, it is fair to say that the lack of consensus on the basis of the preparation of that information makes comparisons more difficult. In our answer to question 5, we suggest that, for there to be confidence in the conclusions drawn from any analysis of the data, it is imperative that the basis of the preparation of that data is more prescriptive than at present, and audited, to avoid ambiguities and ensure objectivity.

CIPFA already collates information from a number of funds who participate voluntarily in the benchmarking of administration costs. It would seem sensible if CIPFA, the recognised industry body, was used to set out a clear basis for the preparation, calculation and submission of administration and investment costs, and to collate and analyse the data.

Efficiencies are already flowing from collaborative working between funds. This was recognised by Lord Hutton in his eponymous report – "*Central and local government should closely monitor the benefits associated with the current co-operative projects within the LGPS, with a view to encouraging the extension of this approach, if appropriate, across all local authorities.*"

We suggest that collaborative working and shared services are the quickest and simplest means of furthering efficiencies in the LGPS. We expand on this in our answer to question 3.

With regard to investment performance, there is little evidence to suggest that a larger fund size corresponds to better performance. However, the data suggests that the relative performance of larger funds is less volatile which may be an advantage in managing contribution rates as local government funds mature.

Academic research suggests that investment performance derives more from asset allocation than stock selection. Flexible investment strategies are required if asset allocation is to be managed effectively and funds with an in-house capability are better placed (refer question 4).

Question 2 – Are the high level objectives listed above those we should be focussing on and why? If not, what objectives should be the focus of reform and why? How should success against these objectives be measured?

The high level objectives seem appropriate. Although linked, the former is more challenging than the latter as deficits have arisen through subsequent events; principally improvements in longevity and low bond yields exacerbated by QE. Recent reforms to the Scheme have taken action to manage deficits as a future problem but have done very little to address accrued deficits. The only modestly helpful action was the move from RPI to CPI and it is difficult to see any other acceptable actions in a similar vein. A rise in bond yields will go a considerable way to resolving this issue and recent market moves in bond yields suggest some normailisation is occuring but it is only likely to play out over the long term – something that pension funds can sustain.

Question 3 – What options for reform would best meet the high level objectives and why?

In this report, Lord Hutton recognised the benefits that were accruing from the collaborative working of local government pensions schemes. *"Central and local government should closely monitor the benefits associated with the current co-operative projects within the LGPS, with a view to encouraging the extension of this approach, if appropriate, across all local authorities."*

The pressure on public finances means that funds are identifying and realising savings and efficiencies. The collation and publication of comparable data on fund performance will drive that further (see detail in question 5).

Austerity in local government is accelerating this trend in several areas; procurement (framework agreements), joint working (Westminster, Hammersmith & Fulham and Kensington, Northamptonshire/Cambridgshire) and related initiatives (Lancashire/Cumbria).

As one of Wirral's transformation projects, the council is working through plans to share key services with its neighbouring council Cheshire West and Chester. In conjunction with this, Merseyside Pension Fund has set up a joint initiative with Cheshire Pension Fund to work together on implementing the 2014 reforms with a view to standardising systems, policies and procedures. This will facilitate the development of future joint working arrangements.

Berkshire, Buckinghamshire and Oxfordsire pension funds are also working in a similar direction.

Question 4 – To what extent would the options you have proposed under question 3 meet any or all of the secondary objectives? Are there any other secondary objectives that should be included and why?

All the secondary objectives would be achieved to a greater extent. Looking at the objectives, the following points should be made:

- Existing data suggests that pension funds need a minimum critical mass for a specialist, in-house investment resource to be viable.

- Larger funds have more cost effective administration (objectives 4 and 5)
- Investments rather than administration is far more significant in terms of overall impact on cost. A specialist, in-house resource provides for flexibility of investment strategies, access to higher quality staffing resources, meeting objectives 2, 5 and 6.
- Larger funds will generally pay lower fees but the rate of reduction in investment fees decreases relative to increasing scale.
- A focus on investment fees in absolute terms is misguided. Investment fees should be assessed relative to the outperformance achieved. To illustrate this point:

    1. A fund could invest passively with an external manager, pay very low investment management costs and match its strategic benchmark.
    2. A fund could be internally managed (either actively or passively), have low investment management costs but underperform its strategic benchmark.
    3. A fund could invest actively with external managers, have higher investment management costs but outperform its strategic benchmark.

Providing the scale of outperformance exceeds the costs incurred, outperformance with higher costs provides better value than investment performance that is in-line or below its benchmark with lower costs.

As pension funds have bespoke benchmarks derived from the actuary's assessment of their particular circumstances, peformance should be assessed relative to benchmark not in absolute terms as has been the tendency. Additionally, looking at absolute returns takes no account of the risk incurred. Risk adjusted returns are a widely used industry standard of performance assessment.

Objective 3 is unlikely to be influenced to any significant extent by the size of funds. Larger funds have invested in infrastructure for some time and the lower levels of allocation are more reflective of the assessment of the investment opportunity relative to other assets than a factor of fund size.

Question 5 – What data is required in order to better assess the current position of the Local Government Pension Scheme, the individual Scheme fund authorities and the options proposed under this call for evidence? How could such data be best produced, collated and analysed?

As indicated in question 1, within the LGPS, there is a great deal of information publicly available, however, it is fair to say that the lack of consensus on the basis of the preparation of those figures makes comparisons challenging.

For there to be confidence in the conclusions drawn from any analysis of the data, it is imperative that the basis of the preparation of that data is more prescriptive than at present, and audited to avoid ambiguities.

CIPFA already collates information from a number of funds who participate voluntarily in the benchmarking of administration costs. It would seem sensible if CIPFA was used to set out a clear basis for the preparation and submission of administration and investment costs, collate and analyse the data.

In relation to pensions administration, granular information on the costs of the various functions within a pension fund would help to identify areas of efficiency and good practice. The significant areas of administration and associated costs could be categorized as follows;

- Pension Administration Systems
- Benefit Calculations
- Transfer Calculations
- Pensioner Payroll
- Member Maintenance and reconciliation of contribution returns
- Communications

Focusing purely on costs, risks overlooking some aspects of quality that are less obvious but valuable. The following are examples of activities that will increase administration costs but will have cost and efficiency benefits that will not show up immediately:

- a data cleansing exercise will improve actuarial calculations and reduce the likelihood of incorrect pension payments
- an analysis of longevity of scheme members may reduce contribution rates
- the active management of empoyers with weak covenants in relation to bonds, guarantees and other risk reducing activities

Administration costs

A number of voluntary initiatives have been ongoing for a number of years; one of the most widely used being the CIPFA benchmarking study of administration costs. However, as the numbers are not audited, participants lack confidence in their robustness.

Although SF3 returns are audited and form part of pension funds' annual accounts, there are some inconsistencies in the data nonetheless due to:

- internal/external management of funds
- different auditing regimes
- the allocation of costs between investments, administration and the fund
- greater visibility of Metropolitan funds relative to the more integrated non-Metropolitan funds to the allocation of central charges by administering authorities.

Investment costs

As indicated in question 4, it is necessary that they are analysed firstly as a percentage of AUM and secondly that performance is analysed on a relative rather than an absolute basis. The cost per member basis derived from the SF3 return is meaningless.

To illustrate this, MPF has undertaken an analysis of the investment performance of other Met funds and comparable neighbouring funds over a three year period. An extract of the analysis, reproduced below, shows the pitfalls of limiting analysis to absolute rather than relative returns. A pension fund may have low investment costs but if its investment performance does not match its benchmark, the value foregone is generally far greater than the benefit of the lower costs. It would be reasonable to undertake this analysis over other, longer time periods and update it for 2013 now the data is available, to allow further comparison.

The attached spreadsheet provides further detail on the underlying data (which has been derived from public sources) and the basis of calculations. We are willing to provide further information as required.

	Fund Size	Total administration cost (£ 000)	Total Cost Per AUM	Total Net Cost AUM	Total Net Costs £	Total Net cost per member	Total administration cost per scheme member (£)
Merseyside Pension Fund	**£5,200,000,000**	**£15,143,000**	**0.29%**	**0.09%**	**£4,743,000**	**£38.70**	**123.55**
Cumbria	£1,466,418,000	£4,489,000	0.31%	0.61%	£8,888,254	£204.35	103.20
Cheshire	£2,920,443,000	£11,125,000	0.38%	-2.42%	-£70,647,404	-£924.78	145.63
Lancashire	£4,380,000,000	£12,179,000	0.28%	1.48%	£64,739,000	£470.50	88.51
LPFA	£4,214,161,000	£27,143,000	0.64%	1.24%	£52,427,966	£684.99	354.63
South Yorkshire	£4,687,897,000	£5,168,000	0.11%	1.11%	£52,046,970	£402.86	40.00
Tameside	£11,012,410,000	£13,163,000	0.12%	0.32%	£35,187,820	£130.34	48.76
Tyne & Wear Superannuation Fund	£4,841,462,000	£12,062,000	0.25%	0.45%	£21,744,924	£191.09	106.00
West Midlands Pension Fund	£8,900,000,000	£20,979,000	0.24%	1.24%	£109,979,000	£431.00	82.21
West Yorkshire Superannuation Fund	£8,700,000,000	£6,578,000	0.08%	0.38%	£32,678,000	£140.73	28.33
Total or Average	**£56,322,791,000**	**£128,029,000**	**0.23%**	**0.55%**	**£311,787,530**	**£214.00**	**£87.88**
Volatility / Standard Deviation			*0.16%*	*1.11%*	*£47,015,813*	*£434.26*	*£93.02*

Notes for sources of data
All data on scheme members and investment and adminstration costs taken from 2012 SF3 release
Data on Fund size, investment targets and investment performance taken from annual reports and Statement of Investment Principles investment performacne is 3 years to 2012
Exceptions and assumptions : where there is no published target or the target is to exceed specific benchmark a figure of 0.1% is used West Mids is targeted alpha, from their Annual Report