WIRRAL COUNCIL

PENSION COMMITTEE

15 SEPTEMBER 14

SUBJECT:	LGPS UPDATE
WARD/S AFFECTED:	ALL
REPORT OF:	STRATEGIC DIRECTOR TRANSFORMATION AND RESOURCES
KEY DECISION?	NO

1.0 EXECUTIVE SUMMARY

1.1 This report updates informs Members of the Government Response on “Freedom and Choice in Pensions“ Consultation and the potential impact on the Local Government Pension Scheme.

1.2 The report also provides an insight to the possible direction of travel in regard changes to ill health provision and pension provision for councillors.

1.3 At September’s Committee meeting, the fund reported DCLG’s consultation - “LGPS Consultation – Opportunities for Collaboration, Cost Savings & Efficiences”. In July, a response was approved by the Chair of Committee and is attached as appendix 1.

2.0 BACKGROUND AND KEY ISSUES

“Freedom and Choice in Pensions” Consultation

2.1 The Chancellor’s spring 2014 Budget announced changes to defined contribution (DC) schemes from 2015; allowing members to take their entire contribution pot as a retirement lump sum.

As a consequence, transfers from public service pension schemes to DC schemes would be restricted, except in limited circumstances, due to concern that an increase in demand for transfers would have a negative impact on the public purse.

2.2 The Government issued the above consultation in March 2014, which ran for a twelve week period, to address the implications of the reforms.

2.3 HM Treasury published its response to the consultation on 21 July 2014, with the key proposals on how it intends to proceed:

- Transfers from private and funded public sector defined benefit schemes to continue as this would not cause an additional cash burden for the State as these would be paid by individual pension funds.

- Independent financial advice at the member's own cost will be mandatory for transfers where capitalised pension savings are above £30,000.

- There will be a further consultation to extend the flexibilities afforded to DC to defined benefit schemes i.e. ability to take full or partial withdrawals of pension benefits.

- The flexibilities will be extended to AVCs within defined benefit schemes if the scheme rules allow it.

- Minimum pension age to access benefits will increase from 55 to 57 from 2028 for most schemes

2.4 New anti-avoidance tax rules will be put in place to ensure that individuals who take more than their tax free allowance from the age of 55 will be subject to a reduced annual allowance of £10,000, from the usual £40,000.

2.5 The intention is to legislate on these issues in Autumn 2014 through a Pensions Tax Bill and amendments to the recent Pension Schemes Bill

Shadow Advisory Board – ill health Review

2.6 The Administration and Communications sub-committee of the Shadow Scheme Advisory Board has prepared a paper, setting out a range of options for changes to the ill health arrangements under the LGPS.

2.7 The options presented focus on the merits of a move from the current three tier process, to either a single tier or a two tier structure. This would be accomplished by replacing the third tier-flat rate reviewable ill-health pension, with a compensation payment made by the employer – its intention is to tide the member over until they become capable of gainful employment.

2.8 The justification for moving to a single tier benefit is that 75% of all ill health retirements are at tier one. The proposal indicates that the additional cost is offset by a reduction in the level of enhancement.

A single tier benefit would be simpler to administer; it would also remove the current administrative overhead of appeals where the member disagrees with the tier they have been awarded.

2.9 The option of a two tier ill-heath system is consistent with other public sector schemes, but consideration is required as to the level of benefit in the respective tiers. Currently, the NHS and Teacher pension schemes provide for a flat rate benefit at the second tier.

2.10 There is also the potential for a reviewable two tier system and the re-qualification of the entitlement test from the current two step process which requires that;

- the member must , as a result of ill healthy or infirmity of mind or body, be permanently incapable of discharging efficiently the duties of the employment and;

- the member must not be immediately capable of undertaking any gainful employment (i.e. paid employment for not less than 30 hours in each week for a period of not less than 12 months).

2.11 There is also a consideration as to whether it is appropriate that, in order for a member to qualify for enhancement, they would need five years membership as required prior to 2008, rather than the current qualification of two years.

2.12 The Shadow Scheme Advisory Board reviewed the paper on 9 June and has asked for further work by the sub-committee, specifically to narrow the options down and report back with a costed appraisal of the potential new structure. There would then need to be an informal consultation process with employers and unions before making recommendations to the Secretary of State.

Councillors' Pensions

2.13 The LGA has continued to champion the case for allowing councillors to have access to the LGPS in England and Wales.

2.14 The alternative options of a Group Personal Pension or an LGA run trust scheme are also being considered, with the former being simpler to set-up but not tailored to the needs of councillors, and the latter more complex, but more appropriate.

2.15 The options are currently with the political groups to assess demand and preference. The groups are also being informed by a data gathering exercise from individual LGPS Funds.

3.0 RELEVANT RISKS

3.1 Given the new flexibilities being introduced for DC Schemes there is a risk that, admitted bodies, in managing their liability and risk, may try to encourage employees to transfer their accrued rights to a DC vehicle prior to retirement by means of an enhanced transfer value.

3.2 As the LGPS remains a secure, premium pension scheme in regards the value of the benefit package, for the majority of cases, it would not be in the financial interests of the member to transfer their benefits to a DC scheme.

There is also the increased likelihood of a re-occurrence of 'mis-selling' of pensions, similar to the scandal that was experienced in the late 1980s.

4.0 OTHER OPTIONS CONSIDERED

4.1 The Shadow Scheme Advisory Board Sub Committee is currently undertaking an options appraisal to determine the most equitable framework to provide affordable ill heath provision within the LGPS.

5.0 CONSULTATION

5.1 Not relevant for this report

6.0 OUTSTANDING PREVIOUSLY APPROVED ACTIONS

6.1 None associated with the subject matter.

7.0 IMPLICATIONS FOR VOLUNTARY, COMMUNITY AND FAITH GROUPS

7.1 There are none arising from this report

8.0 RESOURCE IMPLICATIONS: FINANCIAL; IT; STAFFING; AND ASSETS

8.1 The new budget changes may result in the LGPS experiencing an increase in the external cashflows as outward transfer payments increase. This is more likely to have a greater short-term impact, as members seek to transfer funds ahead of the legal requirement of acquiring costly financial advice from April 2015.

8.2 However, the transfer of pension obligations elsewhere would result in a reduction in the long-term costs of the Scheme, reduce exposure to improvements in longevity and decrease the likelihood of future pressure to reform the benefit structure

8.3 The operational processes in dealing with transfer requests will need to be adapted, to ensure that the requirement to obtain independent financial advice before electing to transfer is appropriately implemented and communicated to the member

8.4 If, after further consultation, Government proceeds with allowing similar flexibilities to defined benefit members, there will be a reduction in the administrative burden of facilitating transfer payments for members.

However, if defined benefit schemes are required to directly offer arrangements such as cash drawdown, then that will add significant further complexity and will be challenging to communicate to Scheme members.

9.0 LEGAL IMPLICATIONS

9.1 There are none arising from this report

10.0 EQUALITIES IMPLICATIONS

10.1 Has the potential impact of your proposal(s) been reviewed with regard to equality?

(b) No, because Department of Communities and Local Government undertake equality impact assessments with regard to the statutory reform of the LGPS.

11.0 CARBON REDUCTION AND ENVIRONMENTAL IMPLICATIONS

11.1 There are none arising from this report

12.0 PLANNING AND COMMUNITY SAFETY IMPLICATIONS

12.1 There are none arising from this report

13.0 RECOMMENDATION/S

13.1 That Members note the report.

14.0 REASON/S FOR RECOMMENDATION/S

14.1 There is a requirement for Members of the Pension Committee to be kept up to date with legislative developments as part of their decision making role.

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APPENDICES

Appendix 1. Response to consultation "LGPS Consultation – Opportunities for Collaboration, Cost Savings & Efficiences"

BACKGROUND PAPERS/REFERENCE MATERIAL

BRIEFING NOTES HISTORY

Briefing Note	Date

SUBJECT HISTORY (last 3 years)

Council Meeting	Date
The LGPS update is a standing item on the Pensions Committee agenda.	

APPENDIX 1

Victoria Edwards
Department for Communities and Local Government
5/F6 Eland House,
Bressenden Place
London
SW1E 5DU

Direct Line: 0151 242 1309

Please ask for: Peter Wallach

Date: 3 July 2014

Dear Ms Edwards

Consultation on Local Government Pension Scheme: Opportunities for collaboration, cost savings and efficiencies

I refer to the above mentioned consultation document dated May 2014 and I am responding to the invitation for comments on behalf of Wirral Council in its capacity as the Administering Authority for Merseyside Pension Fund (MPF).

Merseyside Pension Fund, which is part of the Local Government Pension Scheme (LGPS), is the 5th largest of the 89 funds with assets of £6bn. MPF undertakes the LGPS pension administration and investments on behalf of the five Merseyside district authorities and over 150 other employers on Merseyside and elsewhere throughout the UK. The Fund has over 125,000 active, deferred and pensioner members.

MPF has a long history of running money internally as well as investing with active and passive external investment managers and we welcome the opportunity to draw on this experience in contributing to the consultation. MPF responded to last year's call for evidence and has generally been supportive of the LGPS reform agenda and the desire to improve governance and best practice. We are concerned that the emphasis of the reforms has moved from improving investment returns and addressing deficits to a focus on cutting costs, apparently without regard to the potential implications.

We are aware that a number of detailed submissions are being prepared by other funds and interested parties. Accordingly, our response emphasises those elements of the consultation most relevant to our experience. This does not mean that those other matters are of less importance to us.

Our response focuses on the following issues:

MPF's investment strategy has delivered, on average, a 0.8% outperformance of its strategic benchmark for each of the last five years. This has derived from active management (across equities, bonds and alternatives) rather than from asset allocation decisions. Net of costs, this equates to approximately £30m p.a. We are concerned with any changes which threaten our ability to provide these returns.

We already make considerable use of passive management (27%) in our investment strategy. We have identified assets and markets where we believe it is more applicable and have implemented it accordingly. However, it is something that is kept under review and

further compulsory moves to passive would, in our experience, result in a sub-optimal investment strategy.

Turning to our active equity managers (38%), WM has analysed our experience over the past five years. Of our thirteen managers, only one has detracted value over that period and overall value added, net of costs, has been £9m p.a. The contribution of our internal equity managers to this has been material.

The emphasis of this and the previous consultation has tended to be on returns in isolation, rather than in the context of the risk taken. We believe that it is very important to have regard to risk-adjusted returns. This can be considered both at the asset allocation level and the manager level and is something to which we drew attention in our response to the call for evidence.

As a founder member of the Local Authority Pension Fund Forum, MPF has been a long-standing advocate of a responsible approach to investment. An increased use of passive management is likely to curtail our ability to implement our responsible investment strategy.

Q1 Savings from CIVs

Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments? Please explain and evidence your view.

Greater involvement in pooling of assets can materially reduce fees for LGPS funds with the greatest benefits likely to be achieved by the smaller funds. As discussed later, CIVs are not necessarily the most efficient way of achieving this. CIVs will only achieve useful economies of scale and real savings to LGPS if they are implemented carefully. There is a real risk that badly implemented CIVs could end up costing the LGPS significant amounts through reduced net returns which would more than offset any fee savings.

We hold the view that participation in CIVs should be voluntary. We regard competition and choice as the best way to achieve high standards, efficient low cost products and positive net returns. In theory, savings can be achieved by pooling existing LGPS mandates into larger mandates and there are possibly too many managers and mandates across the LGPS, with average mandate size below optimal. However, the extent of savings may not be as much as expected.

We can see little benefit in establishing new CIVs for passive investments. Much passive investment is already done through pooled vehicles. Effectively, our passive management comes at no cost to us with the low fees we pay being offset by the efficient management of the pooled vehicle achieving index performance net of costs. Based on Hymans analysis, there would be savings for smaller LGPS funds in accessing lower annual management charges but these could be obtained more effectively elsewhere than through a CIV and the attendant additional costs it would bring.

For active mandates, CIVs may make sense in certain areas and offer savings, possibly around 20% of costs. Savings will vary depending on the mandate – from zero for high quality managers with limited capacity, to significant for some managers able to take on extra funds without increasing costs. The CEM study referenced by Hymans found that the

LGPS was already accessing quite competitive rates for asset management, comparable to much larger funds, so savings from merging mandates may not be as material as forecast.

More significantly, there are also significant drawbacks to consolidation and the use of CIVs, which could result in lower net returns under a CIV model. The consultation does not consider these drawbacks, yet addressing them is central to successful CIVs.

• Many high quality specialist managers may not want to participate in a large scale CIV, for reasons of capacity and client concentration.

• CIVs inevitably involve a loss of individual reporting and reduced manager access. This would undermine our own commitments to reporting and accountability, but more significantly would also make it harder to evaluate managers and understand whether they were still appropriate for our needs. Thus CIVs could increase risks to the fund of financial loss from failing to detect warning signs at deteriorating managers.

• Of importance to MPF is that many of the managers we employ take their responsibilities seriously, actively consider environment, social and governance factors in investment decision-making, and engage with us on these issues. With a CIV we will probably not be able to make these requests of managers and will rely on a third party to hold managers to account, with the likelihood that standards will fall.

Implementing CIVs well, involves ensuring they are well managed, well governed, adequately resourced, flexible enough to meet varying needs and different markets. We would recommend and welcome flexible, open CIV structures, where it is possible to create asset classes for particular managers' products relatively easily, and where individual LGPS funds can choose the most appropriate funds for them.

Other options for pooling assets appear to have been overlooked, such as fund manager led pooled funds and framework procurement arrangements for fund managers. Local and national frameworks have delivered considerable savings in their short lifetime and look to be gaining momentum. We recommend that the benefits and cost savings from the frameworks is more fully reflected in any recommendations for change.

An alternative approach, reflecting that the real objective should be to enhance net returns in the LGPS, would be to focus further on the skills and knowledge required to manage investments well. A number of LGPS funds have good track records and it would be helpful if the emphasis was on improving under-achieving funds rather than pulling better performing funds down to the average.

CIVs for unlisted investments

CIVs for unlisted investment are an interesting concept, and the theoretical cost efficiency is appealing, but we regard the practical issues as significant and particularly challenging, because of the illiquid, long term nature of these investments. If poor investment decisions are taken they could be very expensive and difficult to rectify. In addition, there are different issues with different asset classes (e.g. property, infrastructure, private equity, hedge funds) with different approaches required in each area.

Although the fund of funds model comes in for much criticism on the grounds of cost, there are advantages of such an approach, in particular diversification, so that assets are not concentrated in one particular investment and ensuring appropriate due diligence on the underlying holdings.

As a pension fund that already invests directly in alternative assets we have adopted a hybrid approach with a mixture of direct holdings combined with one of more fund of funds. In relation to our hedge funds, for example, our fund of hedge fund manager undertakes due diligence on our direct holdings to ensure appropriate controls are in place and monitored on an ongoing basis. In view of our relationship, this service is provided far more cost effectively than if it were contracted separately.

However, as the proportion of assets allocated to alternatives grows, we are actively exploring the practicality of collaborating on due diligence by pooling expertise and knowledge with other funds in the region. This would enable the sharing of costs and more effective collective negotiation with alternative asset managers. It would support individual decision making and direct investment by LGPS funds. This would potentially be lower cost and simpler than a CIV (which is arguably an unnecessary layer of cost), and more flexible.

This has already occurred in the recent 'Invest for Growth' initiative where five of the larger funds, including ourselves, identified and 'shared-out' due diligence on seven potential investments, and pooled our findings. This led to a number of investments being made but each fund retained the discretion as to which combination of investments was or was not suitable for its own strategy and needs.

An alternative approach for an unlisted asset CIV would be one that invested directly in the assets. Although the most cost efficient approach, it is also the highest risk because diversification is limited, and has the greatest requirements for expert management. We are interested but very cautious about such an approach. The challenges are seen in the PIP which, despite being established by like-minded investors, has still taken a considerable time to become operational.

To summarise, we would be supportive of high quality CIVs for unlisted assets, but this means competent governance, a strong management team and an appropriate strategy. We believe a collaborative approach with other pension funds in the region is a useful first step which could lead to deeper involvement, possibly through a CIV.

Q2. Asset Allocation

Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?

Yes. It is essential that asset allocation is kept with administering authorities. MPF in common with most funds has a bespoke strategic benchmark which is set with regard to factors such as the fund's liabilities, funding level, maturity profile and cash flow profile.

Thus, in implementing its asset allocation, the fund does not simply consider the balance between equities, bonds, alternatives and cash. We also have regard to matters such as (il)liquidity, volatility, style and other risk factors.

Importantly, the increasing maturity of our liability profile combined with the proliferation of employers in the fund creates additional complexity. At the individual employer level there is considerable variation of covenant strength and tolerance of cost volatility. A growing focus of our risk management is to implement individual asset allocations. It will be more difficult to develop this if asset allocation decisions are not taken at a local level.

In order to manage our fund optimally and in the best interests of employers and members, we need to be able to take a sophisticated approach to asset allocation, which means we need access to a wide range of different instruments.

Q3. How many CIVs

How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?

In many respects the number of sub-funds/asset classes is more relevant than the number of CIVs. As discussed previously, we regard choice and competition as very important in ensuring we can access the best possible options for the fund – it keeps the market strong and safeguards against complacency. So, to have several different choices would be appropriate. Combined with the need to be able to reflect detailed asset allocation, this means that there should be access to a reasonable number of sub-funds/asset classes.

Q4 Types and governance of CIVs

What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?

We consider the type of vehicle is less important than many of the other issues with developing a CIV as discussed above: competence, governance, flexibility etc. all of which need to be adequately addressed first. In particular, we note the cost of setting up a CIV is not insignificant, and ensuring CIVs have adequate initial resources is important.

The governance and management of the CIVs becomes particularly important if there is compulsion to use CIVs which are making active investment decisions. Although enhanced governance can help mitigate risks, we consider competition and choice to be far more effective at ensuring that the CIVs are well managed, so this approach should be avoided. The work already underway in relation to the London CIV should provide some useful pointers as to the most appropriate structures.

As mentioned in Q1, we are exploring with other LGPS funds in the North West the potential for collaboration which could lead to the pooling of assets in some way to better co-ordinate mandate selection and achieve economies of scale, including the extent of potential synergies and the various costs involved. We would be supportive of an approach which would allow for local involvement in governance.

More importantly, we believe that collaborative working between funds, particularly in the area of alternatives, has the potential to enhance net of fee returns without necessarily involving a formal CIV.

Q5 Passive Management

In light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance, which of the options set out [below] offers best value for taxpayers, Scheme members and employers?

• Funds could be required to move all listed assets into passive management, in order to maximise the savings achieved by the Scheme.

• Alternatively, funds could be required to invest a specified percentage of their listed assets passively; or to progressively increase their passive investments.

• Fund authorities could be required to manage listed assets passively on a "comply or explain" basis.

• Funds could simply be expected to consider the benefits of passively managed listed assets, in the light of the evidence set out in this paper and the Hymans Robertson report

We believe the best option for taxpayers, scheme members, and employers would be the "comply or explain" option although this could be better posited as "perform or explain". This would underline the need for funds to demonstrate and evidence that they have paid appropriate attention to their investment management fees and the value obtained from them. As stated previously, returns net of fees should be the focus and this would allow funds with good governance and track records the freedom to continue to utilise active management where appropriate.

Passive management is not a low risk option against liabilities and indeed is likely to involve increased risks. Standard indices are increasingly recognised as flawed: over-concentrated, over-exposed to the most overvalued (equities) or indebted issuers (bonds), and "risk inefficient" for long term investors. There is a growing body of evidence that there are persistent pricing anomalies that can be exploited through use of non-market capitalisation weighted strategies. Leading passive investors are moving away from simple passive approaches and using "smart beta" products and "buy and hold" strategies. Furthermore, if a significant portion of the UK's long term asset owners invests passively, systemic risk will be increased, as pricing and selection are left to short term investors and listing authority officials.

Any compulsory use of passive would have significant negative effects on MPF and its employers. In particular, a complete requirement to implement passive would result in the loss of significant value to MPF arising from active management which, eventually, will be reflected in already squeezed local authority and other public sector budgets through increased contributions. It would increase investment risks to the Fund as it would reduce options to manage risks. It would also have implications for our responsible investment strategy.

We believe a strategic approach to the question of active and passive management with regard to returns net of costs is more appropriate.

To demonstrate this, in 2007, MPF undertook a review of its North American equity mandate. The incumbent growth manager had delivered above market returns over the long-term but in a 'lumpy' way with considerable volatility against the benchmark. As this was the sole manager and a substantial mandate, MPF felt the volatility was

disproportionate. Consideration was given to introducing a value style manager to complement the incumbent manager. However, the internal investment team also had regard to academic research suggesting that the US market is very efficient and large companies' indices are difficult to out-perform. Taking account of the likely costs and returns, our ultimate decision was to implement a passive US mandate and that has been in place for seven years or more.

That being said, there is also evidence of persistency of outperformance of mid and small cap stocks. Hence, while we are comfortable with our strategic approach, there may be good reasons why another pension fund may invest actively.

We also took a strategic decision to invest passively in index-linked gilts, some years ago. They are held as a matching asset and, with so few stocks in the benchmark, we believe this limits the opportunity for active managers to add value. However, there will be managers who have outperformed and our view should not limit the approach by other pension funds who may be investing for a different purpose.

The consultation looks at averages, not at best practice and the value that can be added by a well considered use of active management.

The DCLG has already identified governance as deficient in some areas of the LGPS and is taking actions to rectify this. We believe that there is a governance 'dividend' and that governance arrangements at MPF exemplify many aspects of best practice. It would be helpful to allow the new governance measures proposed for the LGPS to bed in and for their impact to be assessed.

Based on our own experience and independent research, we are strongly of the view that appropriate selected managers can add value. However, this does not apply everywhere or to any mandate. Success is significantly more likely if the mandate is in an area where there is increased evidence that active managers can do well (typically markets where information is less widely available and there are fewer brokers, such as less developed market equities, corporate bonds, and small companies); or where the manager has a clear focus on a successful model (e.g. focused high conviction, long term manager, low volatility). We are indeed cautious about investing with "traditional" active managers where they may be a degree of "closet indexation" and no clear evidence of any particular advantage. We are also of the view that managers should be appointed for the long-term and periodic under-performance to be expected and assessed in the context of their investment philosophy.

Our manager selection process has evolved over the past few years to reflect these beliefs. Looking at our roster of external managers, three have been in place for more than ten years, six for nearly six years and four in place for over three. The only manager change we have made in the past three years is a switch of passive manager as a fee reduction measure.

In conclusion, we would acknowledge that the consultation has resulted in a great deal of discussion and re-evaluation of investment beliefs and philosophies by LGPS funds, which is a good thing. Strong governance arrangements and adequate resourcing are important to any sustained improvement in investment performance and we trust that this, too, will be drawn out of this process.

We believe that our experience of using active and passive management in combination with a strong and qualified in-house investment management team, supported by

independent advisors and other strategic advisors, demonstrates the benefits of an informed and pragmatic approach to investment. This can be developed further through collaboration with other like-minded funds. We are not complacent and there are areas where we can improve, particularly in relation to asset allocation. However, we are confident that we are heading in the right direction and are concerned that compulsion (rather than encouragement) in any of the areas of this consultation would be a regressive step for us.

In the long-term, we believe that a focus on investment returns net of fees rather than solely on costs must be the right thing for LGPS funds.

Yours sincerely

Peter Wallach

Head of Pension Fund