Grant Thornton

Stronger futures: development of the LGPS

Improving governance in local government pension schemes
February 2015

Contents

Methodology

This report is based on a detailed survey of our auditors of 29 local government pension schemes. It covers over 30% of funds in England and Wales. We have supplemented the survey findings with more detailed discussions with individual auditors and council officers to understand and identify good practices as well as a review of local government pension scheme annual reports.

Our findings are further supplemented by responses to a survey sent to senior officers and pension committee chairs managing local government pension schemes nationally. This survey included questions on your key challenges, including changes you are making in preparation for the new local pension boards.

Introduction from our head of local government

The local government pension scheme (LGPS) continues to a face a huge amount of change, challenge and scrutiny. Although it remains funded, with £180 billion under management, covering 79% of future liabilities, the LGPS acted to reduce its liabilities by introducing a career average pension scheme in 2014. It is also now preparing for the introduction of local pension boards (LPBs) and coming under the remit of The Pensions Regulator (TPR) from April 2015. Meanwhile, a government consultation on structural reform of the LGPS is in progress. But the scheme is showing that it can meet these challenges. There is a clear commitment across the LGPS to ensuring that it can provide affordable pension benefits for the future.

Grant Thornton has based its second review of governance in LGPS funds in England and Wales on comprehensive research with pension fund senior officers, supported by insights from pension fund auditors. The review will help those with responsibility for managing funds to assess the strength of their governance arrangements. It will also help members of the newly formed LPBs to consider what good governance looks like and how they might best focus their efforts.

In our 2013 report 'Coming of age', we noted the wide variety of practice in the management of LGPS funds. There were many well-managed funds, where pension committees had reviewed and improved how they work to strengthen governance arrangements and to achieve a more sustainable fund. Many funds were learning from each other and sharing expertise and capacity to achieve better results. In other cases, there was scope for significant improvement with working practices remaining largely unchanged.

Since then, LGPS funds have moved to a new career average scheme – called LGPS 2014 – a year ahead of other public sector schemes. This has been a major challenge and the LGPS has implemented it well throughout, with a firm emphasis on effective communication for members and employers as well as strong project management.

The LGPS is responding to heavy external scrutiny and a general push for rationalisation. For many funds, the proactive and voluntary development of shared arrangements based on their own needs, rather than externally imposed reform, is more attractive. Such arrangements can maintain local accountability while gaining economies of scale and shared expertise.

A number of funds are exploring radically different and collaborative ways of working. These include: the establishment of collective investment vehicles (CIVs); shared administrative arrangements; and wider sharing, such as the proposed new asset and liability management arrangement planned between the London Pension Fund Authority and Lancashire County Pension Fund. This arrangement is a great example of moving away from organisational silos and self-imposed geographical boundaries.

There have been several other positive trends across the LGPS since our 2013 review:

- Two thirds of pension committees now receive regular performance reports on administration targets, compared with less than half in 2013
- Nearly 100% of pension committees now receive regular reports on key risks affecting the fund, compared to 80% in 2013
- An increasing number (70% compared to 60% in 2013) have taken a wide range of actions to reduce administration costs
- More internal audit teams are now reporting their plans and work to pension committees (55% compared to 45% in 2013)

A wide variation in practice remains though, with some funds still acting in an isolated and old-fashioned way. In particular, it is clear that for some funds, the focus of management attention remains almost exclusively on investment management and this attention is not always helpful. Other aspects of pension fund management – such as benefits administration, employer covenant and liability management – can often receive little attention from those responsible for pension fund management. The introduction of LPBs from 1 April 2015, the establishment of the national scheme advisory board and the introduction of TPR to the LGPS has the potential to better promote:

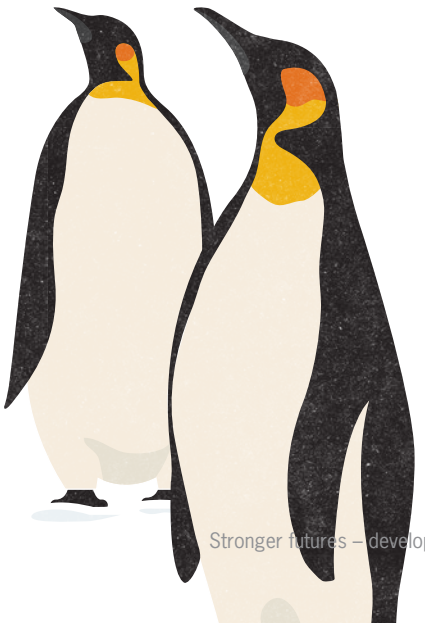
- the recognition and sharing of best practice across the LGPS
- the application of effective governance arrangements across all fund activities.

The governance changes will inevitably bring additional costs to the management and administration of the LGPS at a time when much of the focus is on reducing costs. A challenge for all parties is to implement the changes in a way which brings real benefits. At a local level, the way in which the role of the LPB is developed and implemented will be a key factor.

Meanwhile we await the outcome of the government's response to its consultation on structural reform for the LGPS. Two key proposals consulted on related to the creation of common investment vehicles and a move towards passive management of investments. In our view, any changes need to reflect different local risks and allow funds to make decisions that best reflect their local position. A one-size-fits-all approach would be a detriment to the LGPS as a whole, incurring significant costs and losing the benefits enjoyed by some well managed funds. Such a move would be contrary to the local accountability agenda. A concentration on ensuring consistently strong governance across the LGPS is far more preferable.

This report highlights the key aspects of governance that administering authorities and LPBs should consider as the new governance changes are implemented.

The governance changes will inevitably bring additional costs to the management and administration of the LGPS at a time when much of the focus is on reducing costs. A challenge for all is to implement the changes in a way which brings real benefits.



Areas of priority focus:

Existing pension committee arrangements

There has been limited change in the way most pension fund committees operate since our 2013 review. An honest assessment of the effectiveness of the way the pension committee works will help to inform how a LPB could add value as well as informing how the revised structure might work.

As before, many committees tend to concentrate on the management of investments in isolation, with other key aspects of fund management receiving only limited attention at this level. The scope of performance reporting to pension committees has widened since 2013, although many funds still do not receive regular performance information around liabilities and member cash flows.

Investment strategies

Over half of funds have made significant changes to their investment strategies in recent years. The changes reflect the changing nature of financial markets and aim to reduce risk while maintaining or increasing returns. There is clear evidence that funds are linking their changes to specific local circumstances.

However, there is evidence that some pension committees continue to focus on considering the performance of individual fund managers, rather than on ensuring that the investment strategy is appropriate and on monitoring overall performance. This happens because it is easy to measure, rather than because it is the right thing to focus on.

Recognising the impact of changing liabilities on the sustainability of the fund and the extent to which the fund can offset this impact is key to ensuring that an appropriate investment strategy is in place. However over 45% of funds rely on waiting for the full triennial valuation to obtain this information.

LPBs can help in this area by considering the overall governance arrangements for setting and monitoring the investment strategy.

Identifying and managing risk

The increase in regular reporting of risk management is welcome. The concentration of this reporting remains on investment management risks and to a lesser extent on liability risks. Only about half of all committees include risks around pensions administration and process/control. The implementation of LGPS 2014 was a significant administration risk for funds and yet only 60% of pension committees received progress reports on its implementation.

Consideration of a fund's overall approach to risk management should be a key focus for LPBs. They can help by considering whether its risk management: covers all aspects of fund activity; draws on relevant performance information and takes into account national issues. They should also consider whether there is clarity over the management of and response to key risks.

Capacity, skills and knowledge

Having the appropriate capacity, skills and knowledge in such a specialist area is critical to ensuring effective management of a pension fund. The introduction of LPBs creates the additional challenge of recruiting and training a new group of people while also creating an opportunity to bring in additional expertise to fund management. Over 90% of funds have training programmes for committee members and officers, although over 50% have still not fully implemented the CIPFA skills and knowledge framework.

LPBs can assist by reviewing the arrangements for ensuring those responsible for the management and administration of the pension fund have the appropriate knowledge and access to relevant professional advice when necessary.

Internal controls and internal audit

There is a larger proportion of funds (35%), compared to 2013, where the administering authority's annual governance statement refers specifically to the pension fund arrangements. A small number of LGPS funds have produced a stand-alone statement. This leaves a large proportion with no such statement. We favour the stand-alone statement as it demonstrates accountability and ownership.

The majority of funds have specific internal audit coverage but a significant proportion (15%) do not. Encouragingly, for those that do, reporting of their plans and outcomes to the pension committee has increased from 45% to 55%. The introduction of LGPS 2014 and TPR will require a greater focus on ensuring the quality of member data. This is an area where increased attention would be beneficial across most LGPS funds.

Administration costs

While there has been intense scrutiny around reducing administrative costs, these costs have increased by 20% since 2012. During that period, there have been significant one-off costs for the 2013 actuarial valuation, implementation of LGPS 2014 and changing investment strategies.

The range of reported administrative costs per member is wide, from £12.96 to £68.32, although funds are not yet reporting these consistently, which hinders comparison. Over two thirds of funds have acted to reduce administration costs in recent years. There are many success stories around this although reporting of the savings is still underdeveloped. LPBs can help by reviewing the extent to which the fund: knows and understands its management costs; challenges the status quo; and evaluates the impact of cost reduction measures in terms of savings and quality.

LGPS reform and local pension boards

Introduction

The structure and management of LGPS funds remain under considerable scrutiny. Alongside other public sector pension schemes, there has been significant government attention and new regulations aimed at ensuring that these schemes remain sustainable and affordable. The LGPS is distinct from other public sector schemes in that it is funded with assets of £180 billion, covering 79% of future liabilities.

Senior officers and members told us their biggest challenges were deficit reduction, affordability and dealing with structural reform. At best, structural reform was seen as a distraction rather than likely to assist with affordability or deficit reduction. Over 90% of funds were confident of their ability to deal with these challenges.

LGPS 2014

During 2013/14, funds have implemented LGPS 2014. This moved the LGPS from a final salary scheme to a career average scheme one year ahead of other public sector schemes. It also changed employee contributions rates. This has been a massive and challenging change. An important consideration for any pension scheme in these circumstances is to communicate the changes effectively with members and employers.

Funds have used a range of communication methods to help members understand the implications for their individual pensions, including guidance and examples on websites, employee and employer forums and one-to-one communications.

Implementation of the changes has been difficult, especially given the late finalisation of the regulations. Funds were not able to adjust their financial systems fully as a result, with over 50% reporting the need to use manual interventions in the first few months. Over 40% reported a resultant increased backlog in processing claims. Overall, there is evidence of funds using strong project management to introduce the new arrangements, despite the difficult circumstances.

Governance changes

The Public Services Pensions Act 2013 and the new LGPS governance regulations have introduced further changes for the LGPS, which take effect from April 2015. These introduce:

- local pensions boards to assist each administering authority with ensuring compliance and the effective governance and administration of the funds
- the establishment of a national scheme advisory board to advise the secretary of state, administering authorities and LPBs
- the extension of the work of TPR to the LGPS
- an employer cost capping regime.

These changes require a major investment of time in the initial stages to set up the necessary structures and arrangements, particularly around setting up the new LPBs. The regulations recognise differing local arrangements for the management of LGPS funds, so are not overly prescriptive and leave a lot of flexibility around how administering authorities implement LPBs.

LPBs are not full trustee boards but instead work with the administering authority to help ensure compliance and the effective and efficient governance and administration of the scheme. They are not a decision-making body.

Given the existence of pension committees in some form across all funds, there is a risk that these boards could overlap their role and create another layer of cost and bureaucracy without bringing any benefit to the management of the funds. It is critical, therefore, that administering authorities implement the new requirements in a way that not only meets the statutory requirements but also delivers visible improvements in fund governance.

Overall, there is evidence of funds using strong project management to introduce the new arrangements, despite the difficult circumstances.

In order to do this they should consider:

- the effectiveness of their current arrangements and where greater scrutiny/challenge might be beneficial
- where the various aspects of the fund's management and administration sit and whether these structures need to change to reflect the creation of the LPB, especially around removing any potential duplication
- ensuring clarity of roles and responsibilities
- using this as an opportunity to involve a wider range of skills and experience in the governance of the pension fund
- annual reporting of key measures of impact around governance arrangements.

The timescales for implementing these significant constitutional changes are limited. Funds will need to review how the new arrangements develop during 2015/16 to ensure they achieve a beneficial impact.

Attendees at our October 2014 governance workshop recognised the value that LPBs could bring in ensuring a wider consideration of all aspects of pension fund management.

70% of respondents to our external survey said the LPB could benefit the management of their fund. They quoted expected benefits from a broader focus, different and wider perspectives and greater monitoring and review of governance decisions. A number emphasised the importance of the experience and skills of the individuals appointed to the board in achieving these benefits.

Discussions with LGPS funds indicate that, in preparation for implementation of the LPBs, they have also considered their existing pension committee arrangements. This has included:

- considering whether any elements of work undertaken by the pension committee, any sub-groups and the administering authority's audit committee are now more appropriately undertaken by the local pension board
- generally questioning the terms of reference and membership of existing structures.

70% of funds responding to our external survey were reviewing their existing governance structures alongside the development of the LPB requirements. Most of this work was aimed at eliminating any duplication. But some of the changes were also around improving the effectiveness of the existing pension committee through, for example, widening representation on the committee and broadening its remit.

As LPBs become established, they will need to consider how best to focus their efforts. Initially they will need time to develop a good understanding of how their local fund is managed, the specific risks and issues it faces and how it deals with them. This report will be a useful reference guide to members of LPBs to highlight the potential governance questions they need to be aware of.

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Future structural reform

With 89 separate funds across England and Wales, there has been debate and much work looking at whether this is the most efficient operational structure for the LGPS. There is also a growing debate about whether the management of the funds should be separated from the administering authorities.

The Department for Communities and Local Government (DCLG) consulted on the opportunities for collaboration, cost savings and efficiencies in May 2014. This followed its previous consultation and responses to the 'call for evidence', the analysis of the shadow scheme advisory board and further cost benefit analysis of potential reform options. We still await the outcomes of this consultation exercise.

Consideration of article 18 of the EU directive on Institutions for Occupational Retirement Provision (IORP directive) also raises a legal query as to whether an employer can operate LGPS funds. This will depend on a detailed consideration of the legal requirements and specifically whether the IORP applies to the LGPS.

Overall, there is a growing momentum for structural change within the LGPS, but it is still unclear what form it will take. Meanwhile, the growing use of shared arrangements is delivering benefits to funds through reduced costs, increasing access to relevant expertise and improved quality.

Imposing a single solution on all pension funds will have an adverse effect. For example, requiring all pension funds to adopt passive investment management strategies might provide an appropriate solution for some funds, but will result in a significant reduction in net investment returns for others. Any reform should ensure that:

- all funds are managed effectively to a minimum standard
- collaborative arrangements are pursued by all involved
- the costs, benefits and general learning from collaborative arrangements are clearly evaluated and shared across the LGPS.

Action points

The next 12 months will be formative for most LGPS funds in developing governance arrangements. LPBs and administering authorities should plan to evaluate the costs and benefits of how these operate during 2015/16 with a view to making changes if necessary. In particular, they should consider:

- the benefits achieved through the work of the LPB
- the existence of any overlaps in work and responsibility between the LPB and the work of the pensions committee and other relevant committees
- the benefits achieved through any joint working arrangements.

The growing use of shared arrangements is delivering benefits through reduced costs, increasing access to relevant expertise and improved quality.

Existing pensions committee arrangements

There has been limited change in the way that most pension fund committees or their equivalents operate since our 2013 review. In the context of the forthcoming LPB changes this is, to some extent, not surprising as funds waited for clarification of the new governance structure requirements. It is important that as funds consider the implementation of LPBs, they also consider the effectiveness of their existing working arrangements. An honest assessment of the effectiveness of the way the pension committee works will help to inform how a LPB could add value and how the revised structures might work best.

All LGPS funds now have a pensions committee or an equivalent. The way they work continues to vary widely across the country. Due to the multi-employer nature of many of these funds and the need to have adequate representation, such committees can be large. The LGPS scheme annual report shows that the average membership of such bodies is 10 and most have between five and 15. Meetings of pension committees have been less frequent since 2013, with only 8% meeting five or six times a year compared with 25% in 2013. All other committees meet quarterly.

There has been minimal change in the number of sub-committees and panels operating to support the main pension committees. Two thirds of funds continue to operate as a single committee. A third are supported by a structure of panels and/or sub-committees covering such areas as investments and pensions administration. In comparison, the larger private sector pension trustee boards usually operate with sub-groups covering investments, administration and governance. The value of the sub-groups is to allow a smaller number of people to meet more frequently when necessary and to consider and debate key areas. This enables the full committee to concentrate on the overall performance of the fund and its strategic response.

As before, the focus of the pension committee's work tends to be on the management of the investments. The scope of the committees and the reports they receive reflect this. While this is a key part of managing the pension funds, it means that other important aspects receive only limited attention at this level. Additionally, the focus is often on the performance of individual external fund managers rather than on the overall investment strategy and management of the fund deficit. The industry recognises that, over the medium- to long-term, the choice of individual investment managers has little impact, but setting the right strategy has a much bigger impact on the performance of the fund.

The scope of performance reporting to pension committees has widened since 2013, although many funds still do not receive regular performance information on liabilities and member cash flows. The most significant shift in reporting has been around performance against administration targets. Two thirds of funds now receive regular reports on this compared with less than half in 2013.

An honest assessment of the effectiveness of the way the pension committee works will help to inform how a LPB could add value and how the revised structures might work best.

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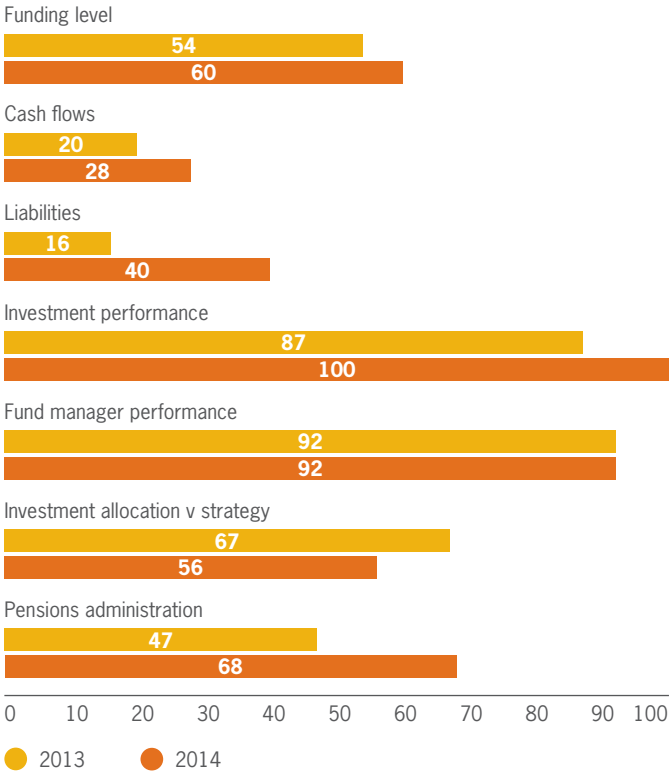
Areas covered by regular performance reporting to pension committee (%)



The scope of performance reporting to pension committees has widened since 2013, although many funds still do not receive regular performance information on liabilities and member cash flows.

Action points

If administering authorities have not already done this in preparation for the new LPBs, it would be good practice for them to consider how they work and in particular ask:

- Are our current arrangements fit for purpose?
- Do they cover all aspects of the management of the pension fund and do they enable us to consider and challenge effectively our overall strategy for the fund's management?
- How has the pension committee contributed to the effective management of the pension fund during the last year or so?
- Does the pension committee have sufficient information and understanding to support its decision making and provide effective challenge?
- What needs to change?

For the newly formed LPBs, a key part of their work in the first year will be understanding: how the pension fund is managed; what the performance information tells them about the financial health and risks of the fund; and the strategic response to those risks. A good starting point would be to consider the scope and usefulness of the performance information provided to the pension committee and how it is used.

Capacity, skills and knowledge

Managing and operating a pension fund requires specialist knowledge and skills. It is a fundamental requirement that those responsible for pension fund management and administration should have the requisite knowledge and understanding. This is enshrined in the Pensions Act 2004. For the LGPS, this has been applied to the members of LPBs within the Public Services Pensions Act 2013, but has not yet been extended to those responsible for pension fund management and administration. Nonetheless, the importance of relevant knowledge and understanding is recognised across the LGPS.

From April 2015, The TPR's role will extend to the LGPS along with other public sector pension schemes. For the regulator, relevant knowledge and understanding among managers is a cornerstone of effective pension fund oversight. They will be looking for: evidence that existing knowledge and understanding has been assessed; that there are adequate plans in place to fill any gaps; and that a programme to ensure such knowledge is kept up to date.

In particular, TPR's code for the governance and administration of public service pension schemes states that schemes should:

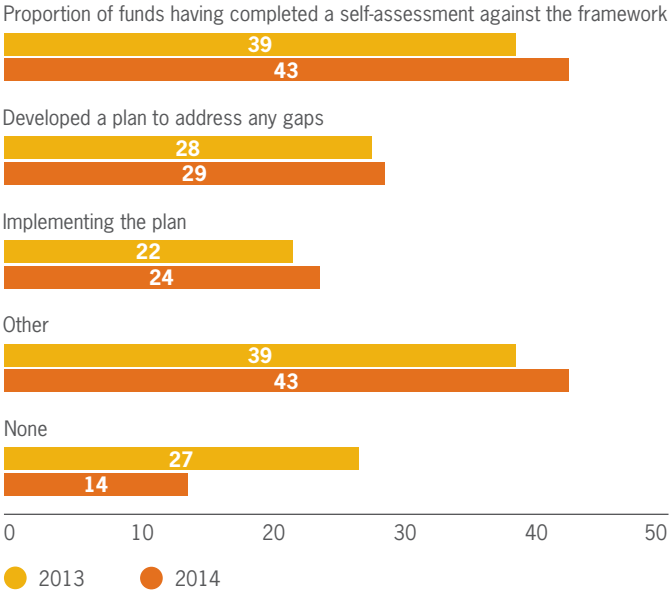
- establish and maintain policies and arrangements for the acquisition and retention of knowledge and understanding for their pension board members
- designate a person with responsibility for ensuring the framework is developed and implemented.

In our view, administering authorities should apply a similar approach to the pension committee members and relevant officers with responsibility for managing the fund.

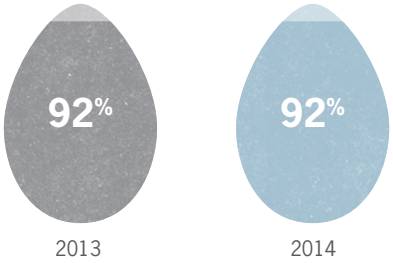
We have seen a small upward trend in funds undertaking the self-assessment against the CIPFA code of practice for knowledge and skills. Most funds have relevant training programmes in place for both committee members and officers, but a small number still do not.

Ensuring that members of the pension committees and LPBs have an appropriate level of knowledge and understanding is an important investment that funds need to make.

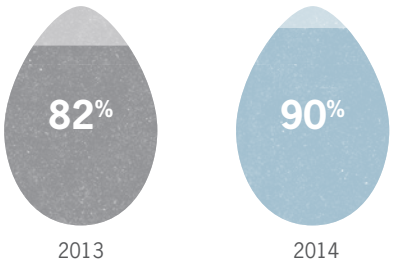
Action taken in response to the CIPFA code of practice knowledge and skills framework (%)



Funds having a training programme for members of the pensions committee



Funds having a training programme for pensions officers



Given the specific nature of LPBs and their oversight of the fund's governance, a number of funds are exploring the option of appointing independent professional trustees to their boards.

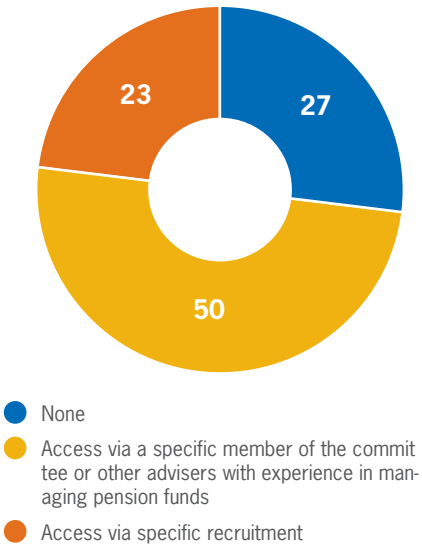
Many funds rely on the longstanding experience of their pension committee members. This is subject to change, especially where there is a change in political composition of the administering authority. The creation of the new LPBs adds an additional challenge because most of these members are likely to be completely new to the LGPS. The list of basic information that the regulations require members of the boards to become familiar with in the first six months is significant. The guidance provided by the LGPS shadow board to accompany the governance regulations encourages funds to:

- appoint a member of the LPB to be responsible for ensuring relevant training programmes are in place
- provide relevant training events/ materials to the pensions committee and LPB members together to help achieve this more efficiently.

Ensuring that members of the pension committees and LPBs have an appropriate level of knowledge and understanding is an important investment that funds need to make.

Given the complexities involved, access to independent professional expertise is important. All funds have access to such expertise around investments and actuarial valuations, but would also benefit from such expertise around the wider governance aspects of the funds. Over 70% of funds report having access to independent expertise either through direct recruitment or by using the wider skills of existing committee members or advisers.

Access to independent professional advice other than relating to investments or actuarial issues (%)



Given the specific nature of LPBs and their oversight of the fund's governance, a number of funds are exploring the option of appointing independent professional trustees to their boards. This is helpful in ensuring that the board has access to independent advisers outside of those professionals who are already advising the pensions committee. It will also enable wider learning from other LGPS and commercial pension funds.

This comes with an additional cost but the benefits may make it worthwhile. As we referred to in 'Coming of age', our previous LGPS review, many large commercial pension funds use independent trustees. The funds think these trustees bring significant benefits in terms of expertise and help to counteract the inherent conflict of interest created by employers operating funds. We encourage all LGPS funds to seriously consider appointing an independent professional trustee to their LPB.

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Action points

LPBs should nominate an individual to ensure there is an appropriate knowledge and skills framework in place for the board and that the board implements it effectively.

LPB members will require a significant training programme in the first six months of 2015 to ensure they have an appropriate level of knowledge and understanding.

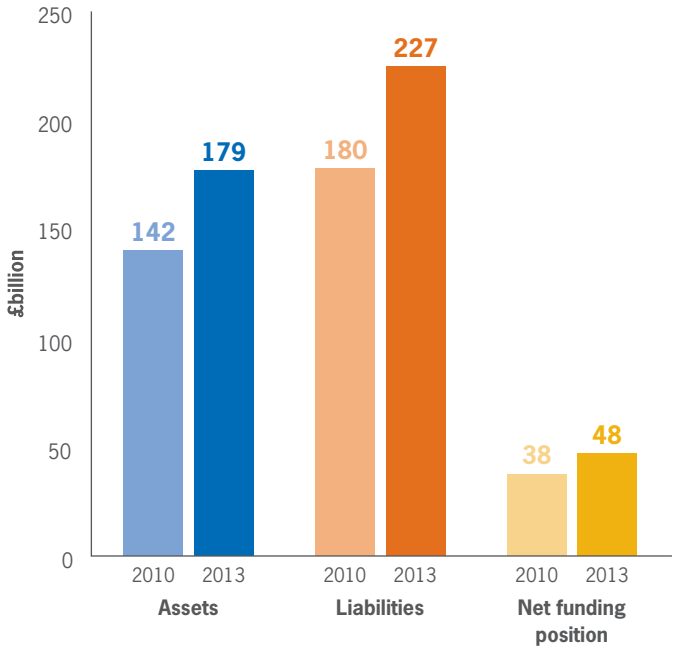
LPBs should also review the arrangements for ensuring those responsible for the management and administration of the pension fund have the appropriate knowledge and skills – both now and with regard to future developments – to manage the fund and have access to relevant professional advice when necessary.

Investment strategies

The investment strategy for any pension fund is a crucial part of the management of the fund. An effective strategy and journey plan – which managers use to change investment strategy as the fund matures – are critical to ensuring the sustainability of the fund and providing for the long-term pension needs of its members.

Following the 2013 triennial review, the overall funding level of the LGPS across England and Wales has remained static at 79%. This masks an increase in asset values over the three years of £38 billion (27%), and proportional increase in liabilities of £48 billion (27%). A challenge for the LGPS, as for the vast majority of funds, is to achieve investment growth that outstrips liability growth, to reduce the funding gap.

LGPS funding position 2010 to 2013



Source: National LGPS report 2014 based on all LGPS actuarial reports for 2013

Over 45% of funds simply wait for the full triennial valuation to obtain this information.

Recognising the impact of the changing liabilities on the overall sustainability of the fund and understanding the extent to which the fund can offset the impact is crucial to ensuring an appropriate investment strategy.

Over 45% of funds simply wait for the full triennial valuation to obtain this information. However, other funds have begun to take a much more active approach around liability management as part of their investment strategy. Some funds use actuarial tools to keep track of their liability position in between triennial valuations and to inform their overall consideration of strategy and performance.

CASE STUDY

The London Pension Fund Authority (LPFA) uses regularly updated liability information to help inform its investment decisions

The LPFA reviews its funding position monthly. An estimated funding level is reported on both the actuarial valuation basis and an internal minimum risk basis. The LPFA's internal objective is to be fully funded on the minimum risk basis. LPFA is currently working with its actuarial advisers on an online liability cashflow generation system from live data. This will be used internally to enhance the current practice of monitoring funding levels and cashflow requirements and to inform investment decisions by taking into account the nature and timing of cashflows needed to meet future liabilities.

Another factor affecting the sustainability of pension funds is the reducing value of income from contributions and increased benefit payments. This happens as local authorities continue to downsize, which increases the number of pensioners. For some pension funds, automatic enrolment, which has increased the number of contributors, has offset this trend. The proportion of funds reporting that their contribution income is sufficient to cover the cost of their current benefit payments has increased since 2012 from 58% to 64%. However, for a significant proportion of funds, income-generating investments form a bigger part of their investment strategies to ensure effective management of their cash flows.

The context for each fund will differ as will the resultant factors.

The proportion of funds reporting that their contribution income is sufficient to cover the cost of their current benefit payments has increased since 2012 from 58% to 64%.

Context and factors affecting local investment strategies

VOLATILITY
Is the current portfolio mix subject to too much volatility and does the fund want to reduce this?

DIVERSIFICATION
Is the portfolio allocated too heavily to one type of investment, which over exposes it to market risk in that area?

INCOME STREAM
Does the balance between contributions and benefit payments mean that the fund needs to generate more income to cover cash flows?

RETURN
Are returns simply too low with the existing strategy to move towards a fully funded position?

FUNDING POSITION
What is the funding level? The closer the fund is to full funding, the lower the risk appetite.

LIABILITIES
What factors affect the liabilities, such as age profiles, discount rates and inflation? When will they be realised?

EMPLOYERS
To what extent can the fund rely on the employer to continue to fund on-going contributions for existing and future liabilities? What do their individual funding positions look like?

RISK APPETITE
How do all these factors affect the fund's risk appetite and therefore the types and balance of its investments?

Over half the funds we audit have made significant changes to their investment strategies in recent years. It remains surprising that this figure is not higher given the challenging circumstances. The changes and reasons for the changes are wide ranging and depend on each fund's circumstances. Examples include:

- increasing diversification, including a move towards more alternative investments such as infrastructure assets, to reduce the risks associated with market failures
- simplifying investment portfolios to reduce unnecessary costs
- adopting an investment strategy that is better matched to the underlying risk appetite and covenant strength of individual employers
- moving into and out of passively managed portfolios, depending on experience of how well this is working for individual funds in terms of cost, return and volatility
- a move towards more income-generating investments to improve cash flows.

Over half the funds we audit have made significant changes to their investment strategies in recent years.

CASE STUDY

Cheshire Pension Fund makes clear links between liability/investment risks and its investment strategy

In April 2014 the Cheshire Pension Fund became the first LGPS fund to implement a multi-employer risk management framework and a trigger based de-risking strategy.

The approach recognises that each group of employers has differing characteristics in terms of funding levels, maturity profile of membership, time horizon in the LGPS and cash flow profiling. The key differences between employer characteristics has led the fund to move away from the one-size-fits-all approach to investments. Each employer has been assigned to one of four investment strategies after careful consideration of the funding position and liability profile. Each investment strategy has a different level of exposure to growth and matching assets.

In addition to the multi investment strategy approach, the fund has implemented a risk management framework which aims to capitalize on funding level improvements by reducing investment risk. The fund believes that a robust risk management framework allows it to be proactive rather than reactive to events and tailor and adapt investment and funding strategies as appropriate. This has been implemented in such a way that there will be no negative impact on employer contribution rates when de-risking actions take place; crucial given the economic climate and the pressure facing most employers.

A relatively small number are also using their investment strategies to hedge against the liability risks they face, particularly around interest rate risks. This is also a relatively small proportion of their fund in most cases. In the commercial sector, the number of funds using hedging strategies is increasing. The LGPS investment regulations place restrictions on the proportion of funds that can be invested in this way. In our view, regulation should concentrate on ensuring appropriate governance rather than restricting specific types of investment.

Funds can gain many benefits from collaboration across the LGPS around investment management.

For example in:

- sharing/increasing the levels of expertise in delivering investment strategies
- ensuring the local focus is on the determination of the investment strategy and overall performance
- reducing investment management costs.

There are now a number of funds working together in relation to investments. These include work on the creation of a collective investment vehicle in London and the South East and the recently announced plans for the asset and liability management partnership, between Lancashire County Pension Fund and the London Pension Fund Authority. The latter plans to pool combined assets of over £10 billion to deliver cost savings and improve performance.

There are still pension funds whose committees concentrate less on setting and monitoring the investment strategy and more on other less productive aspects. Key examples are:

- **receiving and questioning regular detailed performance reports from each fund manager**. The average number of fund managers used is nine and many funds have over 15, so this can be an extremely time-consuming exercise. It is important to monitor and understand the performance of individual fund managers. However, a more summarised version is sufficient to support decisions about strategy and whether manager changes are necessary
- **receiving and questioning lengthy presentations on the global economy and financial markets, without linking clearly to the investment strategy**. Funds need this information to understand the risks facing the fund. But if it does not link to the investment strategy, it is an ineffective use of valuable time.

CASE STUDY

London based funds work together to achieve benefits of collaboration

Over the last two years, the 32 London boroughs and the City of London have been collaborating through London councils to establish a route to reduced costs and overall improved investment returns for the LGPS funds across the capital.

Work is underway to establish a collective investment vehicle (CIV), through which the boroughs will be able to invest, achieving economies of scale, providing a platform for significant cost savings and opening up opportunities to invest in alternative asset classes – for example direct investment in infrastructure – that may not be easily achievable for individual funds. With over £24 billion of assets under management with 87 fund managers, across 253 mandates and £72.8 million paid in fees in 2012/13, collaboration through the CIV is expected to deliver substantial savings.

CASE STUDY

London and Lancashire working in partnership

The London Pensions Fund Authority and Lancashire County Pension Fund have announced the first stage to create a commonly-managed, jointly-invested £10 billion pool of assets overseen by an FCA registered entity. This decision was made to provide the benefits of investment scale, ensure that industry-leading standards of governance are met and to deliver cost savings and improved performance.

The ALM partnership would see each pension fund retain its separate identity and local accountability, by allowing them to pool assets while considering liabilities on a consolidated basis. Such a structure also maintains a framework of local accountability. This model requires no additional legislation, but only the voluntary collaboration and formation of Joint Committees between funds, with clear lines of accountability to the partner Administering Authorities.

Action points

Administering authorities may find it helpful to ask themselves the following questions to consider whether changes are needed around the way in which its investment strategy is set, managed and monitored:

- Do pensions committee members have the right information to help them understand the key factors affecting the funding position?
- Is the investment strategy linked clearly to that understanding?
- Does the fund have or have access to the right skills, knowledge and capacity to deal with the investment strategy?
- Does it consider the funding position and report in between triennial valuations?
- Does the pension committee place sufficient emphasis on setting the strategy and keeping it under review?
- Is the investment decision-making process around individual investments sufficiently transparent and quick?
- Are potential conflicts of interest managed effectively – for example, where funds invest in local infrastructure?
- Where appropriate, are effective due diligence exercises carried out prior to key decisions on specific investments and portfolio changes?

LPBs can help by reviewing the overall governance arrangements for setting and monitoring the investment strategy.

Risk management

Background

Effective risk management is an essential part of any governance framework.

For a pension fund, those risks come from a range of sources including the funding position, investment performance, membership and employer changes, benefits administration, costs, communications and financial systems. Good information is important to help ensure the identification of significant risks.

Current practice

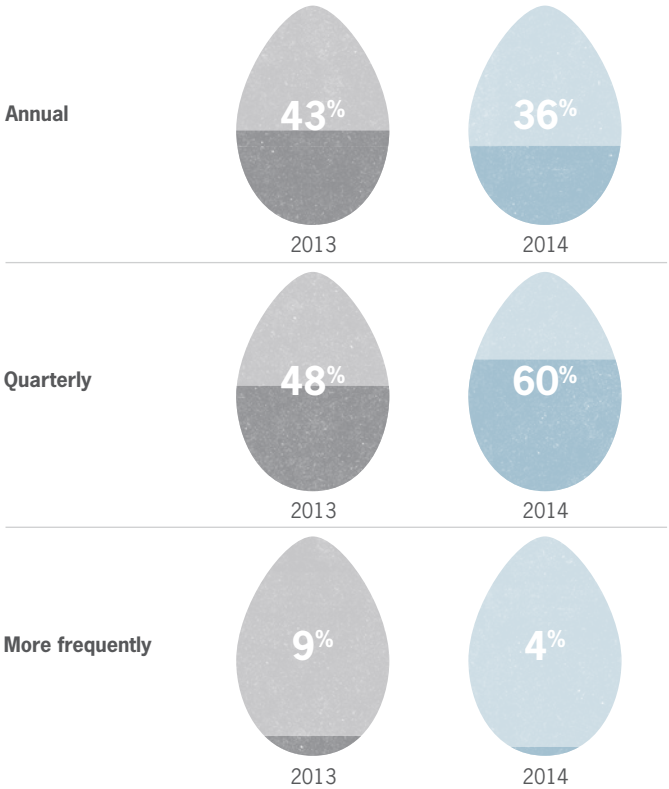
There has been an increase in the number of funds reporting on their management of key risks. Almost 100% now do this. In addition, we have seen an increase in the frequency of such reporting with a move from annual reporting to quarterly reporting.

The concentration of such reporting remains on investment management and, to a lesser extent, liability risks. Only about half include risks around pensions administration and process/control risks.

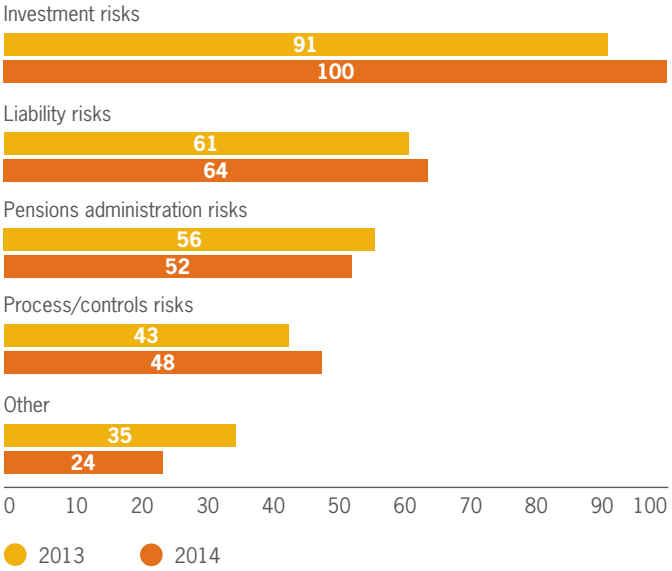
The implementation of LGPS 2014 was a significant change for administration teams, with changes to IT systems, controls and processes required and late finalisation of the detailed regulations. Members and employers needed to do a huge amount of work to understand the impact of the changes fully and to make sure they had somewhere to go for help. We would expect this to have been a key risk for all pension committees to be aware of. While benefits administration teams worked hard to manage those risks in the background, only 60% of pension committees had received progress reports on the implementation of LGPS 2014.

Only about half include risks around pensions administration and process/control risks.

Frequency of reporting on risks to pension committees



Coverage of risk reporting (%)



CASE STUDY

Cumbria Pension Fund demonstrates good governance in practice

Over the last 24 months members of the Cumbria LGPS have been working closely with officers of the fund to implement changes to the structure, decision making and reporting of the Cumbria pensions committee. The drivers for these changes were:

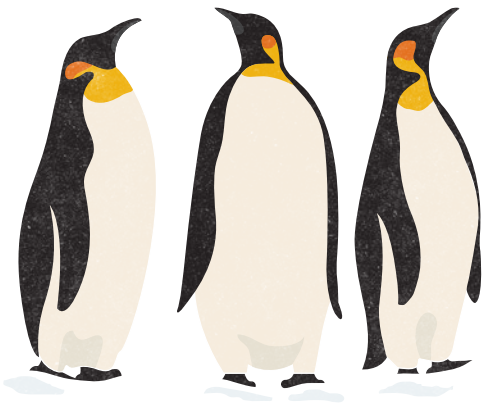
- to recognise and more effectively manage the increasing demands being placed on members due to the volume and speed of change being introduced across local government pensions
- to address best practice evidence on committee management which showed that the most effective funds (both in the public and private sector) were those where committee attention was focused on strategy, risk and governance.

The outcome was a revised structure and reporting which has enabled the committee to focus at a high level on risk, strategy and governance (for both administration and investments matters), while delegating detailed investment management to a smaller more nimble investment sub-group.

The four core themes addressed at each committee meeting are: risk; governance; fund level actuarial performance; and investment strategy. These are now supported by a restructured quarterly monitoring report.

The revised focus ensures risks across the fund are dynamically addressed at each meeting, rather than by the annual production of a risk register. The positive results of this more dynamic risk assessment methodology were clearly demonstrated during the implementation of the 2014 scheme. The risk was progressively escalated through the quarterly risk monitoring report to members over a period of 12 months, who due to the early oversight fully understood the risk and could therefore actively engage in agreeing and monitoring appropriate mitigation actions.

While benefits administration teams worked hard to manage those risks in the background, only 60% of pension committees had received progress reports on the implementation of LGPS 2014.



Action points

Pension committees should ask themselves:

- Do we understand the range of risks we face as administrators of the pension fund to ensure its long-term sustainability and its efficient and effective management?
- Do we know how we are managing those risks and whether we are doing so effectively?
- What needs to change in this regard?

Consideration of the administering authority's overall approach to risk management should be a focus for LPBs. They should ask:

- Does the administering authority have an appropriate mechanism for identifying key risks across all aspects of management of the fund?
- Does risk reporting cover the things that we might expect given information from other sources? Examples include internal audit reports, benchmarking data, complaints data, performance management information, changes in employer and employee profiles, the funding position, and guidance from TPR and the national advisory board.
- Does risk reporting indicate that the risks are being responded to and managed effectively?

Internal control and internal audit

Background

As with any governance framework, reliable systems of internal control are important to assure that processes are operating effectively to reduce the risk of failing to achieve objectives. Internal audit is usually a core part of assuring the effective operation of the internal control system, by reviewing and testing such processes.

Pension administration has become more complex with the introduction of a career average scheme and protections for members due to retire in the short term. This, together with a more complex investment environment, emphasises the need for effective internal control.

Current arrangements

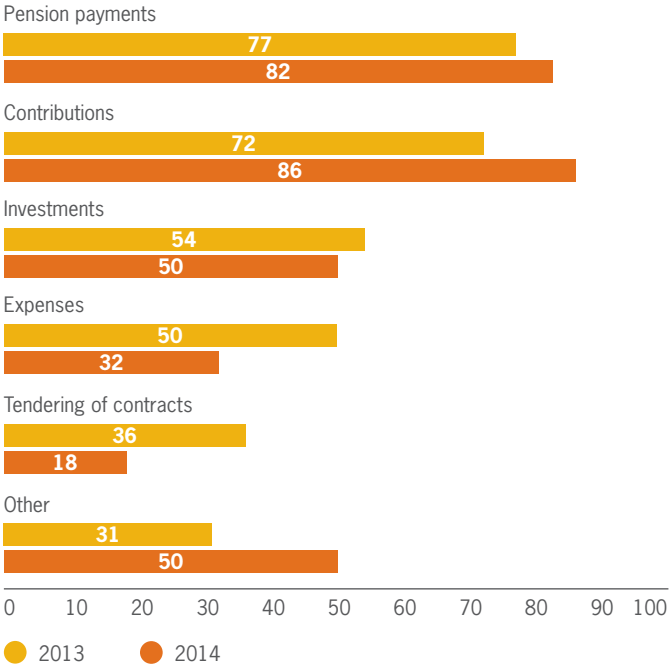
Most pension funds are just one element of the work of the wider local authority. The council's audit committee and internal audit considers the internal control arrangements as part of that wider framework.

There is now a bigger proportion of funds, (35%, compared to 27% in 2013), where the council's annual governance statement refers specifically to the arrangements within the pension fund. A small number have drafted stand-alone governance statements for their pension funds. These go beyond the statutorily required governance compliance statements and give a clear picture of how the fund assesses it risks and assures its management. They also highlight any areas for improvement with linked actions. These demonstrate the emphasis being placed on strong governance for those pension funds.

The majority of funds have specific coverage by internal audit, but a significant proportion (15%) do not. The work that internal audit completes on the wider activities of the administering authorities is unlikely to give the necessary assurance over the pension fund risks, given how specific those risks are.

The majority of funds have specific coverage by internal audit, but a significant proportion (15%) do not.

Pension fund coverage by internal audit (%)



There has been an increase in internal audit reporting their plans and work to pension committees – from 45% in 2013 up to 55%. Administering authorities will need to consider whether the work of internal audit should be reported to the pension committee and/or the LPBs. Their work will sit clearly within the local pension board's role, but the pension committees may also consider that they need this assurance to help them manage the fund.

The scope of internal audit work has also broadened slightly since 2013, giving a wider coverage over the activities and risks of the pension funds. The other coverage shown above includes:

- employer site visits to gain assurance over the accuracy of contributions and member data from employers
- reviews of new IT systems
- reviews of the implementation of auto-enrolment.

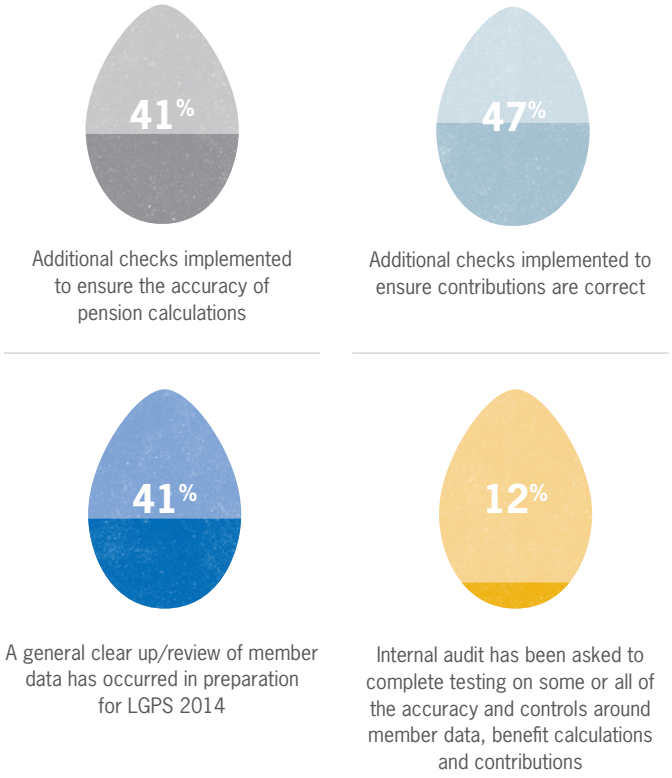
Under 50% of funds have changed their processes to improve data quality linked to the implementation of the career average scheme, indicating this is a key area of development for many funds.

The career average scheme introduces the need for a heavier emphasis on ensuring effective data quality. With a final salary pension scheme, the concentration tends to be on ensuring the accuracy of the data at the point at which the pension is drawn, but with a career average scheme the pension is calculated and attributed annually. TPR emphasises strongly the importance of data quality. It states that:

- schemes should have policies and processes to ensure that data is monitored on an ongoing basis to ensure its accuracy and completeness, regardless of the volume of scheme transactions
- this should be in relation to all membership categories, including pensioner member data, where queries may arise once the pension is in payment
- schemes should adopt a proportionate and risk-based approach to monitoring based on any known or historical issues
- this is particularly important in relation to the effective administration of career average pension schemes, which are required to hold significantly more data
- schemes should review their data continually and carry out a full data review at least annually.

Under 50% of funds have changed their processes to improve data quality linked to the implementation of the career average scheme, indicating this is a key area of development for many funds.

Proportion of funds making changes to improve data quality following the implementation of LGPS 2014



CASE STUDY

Merseyside pension fund strengthens arrangements for data quality in response to LGPS 2014

This fund has increased its checking resources in preparation of the implementation of the career average pension scheme. A focus for the coming year will be to strengthen data quality and progression of the programme to bulk upload data from its largest employers.

Gaps in the system resulted in manual calculations for a significant number of benefit and transfer calculations. This necessitated a new system of control resulting in a thorough accuracy check of benefits and cash flows.

Action points

The local pension board needs to understand the extent to which assurance is provided over the internal controls affecting the board's main risks. The board should seek assurance that this covers the whole range of activities.

Given the newness of the career average scheme, an emphasis on understanding and gaining assurance over data quality controls is advisable.

Administration costs

Background

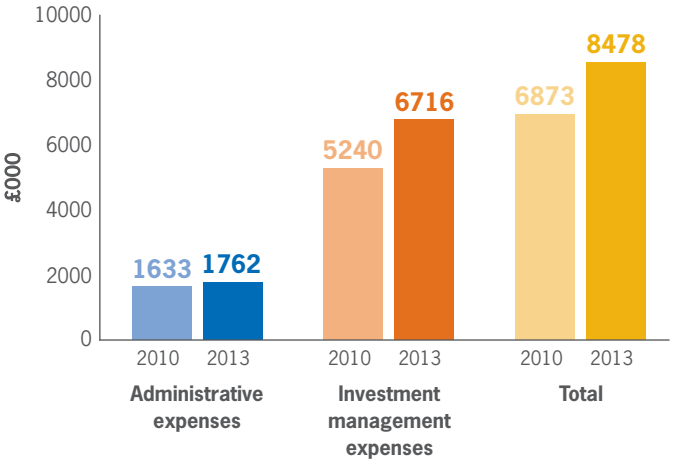
The national focus on the administration costs of the LGPS has continued. The existence of 89 separately managed funds in England and Wales raises questions about whether some re-organisation of those funds could improve performance and reduce administration costs. These could include the costs of administering the fund as well as the cost of investment managers and investment transactions.

It is important for any organisation to keep its administration costs down but especially so in this context. During 2013/14, funds have implemented the LGPS 2014 and dealt with the 2013 triennial valuation. Both have increased administration costs in this period. Due to the much more complex nature of LGPS 2014, changes in controls and processes are necessary to ensure that member data is accurate and provide the correct basis for ensuring that contributions and pension payments are stated correctly.

Additionally the types of changes in investment strategies have led to more one-off costs as funds have changed investment managers and portfolios. Unsurprisingly, therefore, a comparison between 2012 and 2014 shows an increase in total administration costs, including investment management, of over 20%.

Investment transactional costs are often 'lost' in the cost of purchases and sales and would be additional to this cost. Where funds have been able to estimate this value, they have identified an average additional investment management cost of £1.2 million. Implementation of CIPFA's 'Accounting for local government pension scheme management costs' guidance in the 2014/15 financial statements should help to ensure that administration and investment management costs are reported more consistently and therefore create a more useful base for comparison and benchmarking.

Average costs per fund



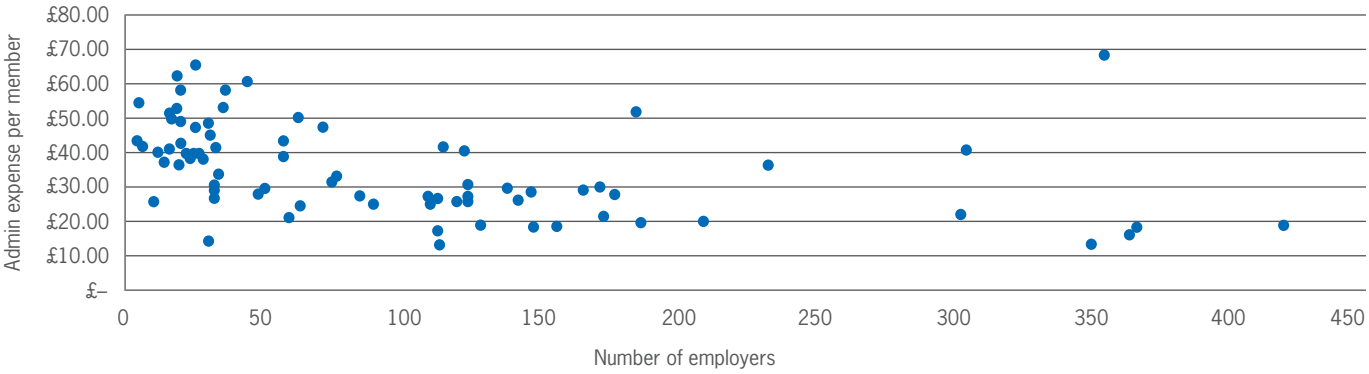
Unsurprisingly, therefore, a comparison between 2012 and 2014 shows an increase in total administration costs, including investment management, of over 20%.

Funds need to benchmark investment management costs in the context of the overall size and complexity of the portfolios and in the context of the net return achieved against the individual target set by the fund.

Administrative costs are slightly easier to benchmark although there is a range of practices that may affect the accuracy of the reported figures. An analysis of the figures reported in the 2013/14 accounts of all funds in England and Wales shows a very wide variation in cost per member from £12.96 to £68.32. Many, although not all, of the higher costs relate to London-based funds where higher salary levels may have an impact.

An analysis of the figures reported in the 2013/14 accounts of all funds in England and Wales shows a very wide variation in cost per member from £12.96 to £68.32.

Admin expense per member



The implementation of LPBs from 1 April 2015, together with potential increases in reporting requirements to a range of bodies under the LGPS regulations, will again increase administration costs.

We have seen an increase in funds acting to reduce their administration costs since our 2013 report with 70% taking a wide range of measures. Some of these have been around investment management and achieved by moving to passively-managed portfolios, reduction in the number and complexity of manager portfolios and re-negotiation of fund manager costs.

About 20% of funds are now using some form of collaborative framework or shared service arrangement and this is a growing trend. However, funds are still poor at quantifying and reporting the savings achieved through such steps.

We have seen an increase in funds acting to reduce their administration costs since our 2013 report with 70% taking a wide range of measures.

CASE STUDY

Cheshire Pension Fund reduces investment management fees

The fund undertakes a fundamental review of manager fees on a bi-annual basis. This led to a reduction in fees for 2013.

CASE STUDY

LGPS national procurement framework delivers real benefits

The LGPS procurement framework has continued to grow. The range of services available under the framework now includes actuarial, benefits and investments consultancy services, global custodian services and legal services. Thirty-seven contracts have been let under the framework with participants benefiting from significant reduced procurement timescales and costs. A further 20 contracts are in negotiation. Although in its infancy, by March 2014 funds had already saved £8 million via the national framework. Over half of the LGPS funds have engaged with the project.

A recent strong example has been a collaboration of three funds, Hackney, Suffolk and Norfolk, negotiating together for custodian services under the framework, with overall estimated savings of £1.5 million achieved, and with a procurement process reduced from months to weeks.

CASE STUDY

Peninsula Pensions – one of the latest shared pension administration services

Over the past 18 months Devon County Council and Somerset County Council have been working together to build a shared administration pension service to improve customer service and value for money. The new service, Peninsula Pensions, was launched in September 2013. There were one-off additional set-up costs but the longer term aim is to improve the efficiency of the pension administration team, provide an improved service to the customer and help keep costs low. A review of the costs and efficiencies achieved will be done after the first full year of operation.

An immediate visible improvement, and in response to requests from customers, is the new self-service Peninsula Pensions website. This provides all customers with immediate and up-to-date pension information to keep track of their pension status and any news relating to it.

Action points

One focus for the LPBs should be around understanding the extent to which the administering authority:

- knows the level of its administration costs, including investment management expenses
- looks to achieve efficiencies in them and challenges the status quo
- evaluates the impact of such measures in terms of savings achieved and quality.

It will be important to recognise that there are new requirements that will result in increased costs in some aspects of the fund management.

Appendix 1:

Action points for local pension boards and administering authorities

Areas of focus	Key responsibility	
LGPS reform and LPBs	**LPBs**	**Administering authority**
The next 12 months will be formative for most LGPS funds in developing governance arrangements. LPBs and administering authorities should plan to evaluate the costs and benefits of how these operate during 2015/16 with a view to making changes if necessary. In particular, they should consider: • the benefits achieved through the work of the LPB • the existence of any overlaps in work and responsibility between the LPB and the work of the pensions committee and other relevant committees • the benefits achieved through any joint working arrangements.	✓	✓
Existing pension committee arrangements		
If administering authorities have not already done this in preparation for the new LPBs, it would be good practice for them to consider how they work and in particular ask: • Are our current arrangements fit for purpose? • Do they cover all aspects of the management of the pension fund and do they enable us to consider and challenge effectively our overall strategy for the fund's management? • How has the pension committee contributed to the effective management of the pension fund during the last year or so? • Does the pension committee have sufficient information and understanding to support its decision making and provide effective challenge? • What needs to change?		✓
For the newly formed LPBs, a key part of their work in the first year will be understanding: how the pension fund is managed; what the performance information tells them about the financial health and risks of the fund; and the strategic response to those risks. A good starting point would be to consider the scope and usefulness of the performance information provided to the pension committee and how it is used.	✓	
Capacity, skills and knowledge		
LPBs should nominate an individual to ensure there is an appropriate knowledge and skills framework in place for the board and that it is implemented effectively.	✓	
Administering authorities should ensure that an appropriate training programme is delivered in the first six months of 2015 to ensure the LPB has an appropriate level of knowledge and understanding.		✓
LPBs should also review the arrangements for ensuring those responsible for the management and administration of the pension fund have the appropriate knowledge and skills – both now and with regard to future developments – to manage the fund and have access to relevant professional advice when necessary.	✓	

Appendix 1:

Areas of focus	Key responsibility	
Investment strategies	**LPBs**	**Administering authority**
Administering authorities may find it helpful to ask themselves the following questions to consider whether changes are needed around the way in which its investment strategy is set, managed and monitored: • Do pensions committee members have the right information to help them understand the key factors affecting the funding position? • Is the investment strategy linked clearly to that understanding? • Does the fund have or have access to the right skills, knowledge and capacity to deal with the investment strategy? • Does it consider the funding position and report in between triennial valuations? • Does the pension committee place sufficient emphasis on setting the strategy and keeping it under review? • Is the investment decision-making process around individual investments sufficiently transparent and quick? • Are potential conflicts of interest managed effectively – for example, where funds invest in local infrastructure? • Where appropriate, are effective due diligence exercises carried out prior to key decisions on specific investments and portfolio changes?		✓
LPBs can help by reviewing the overall governance arrangements for setting and monitoring the investment strategy.	✓	
Risk management		
Pension committees should ask themselves: • Do we understand the range of risks we face as administrators of the pension fund to ensure its long-term sustainability and its efficient and effective management? • Do we know how we are managing those risks and whether we are doing so effectively? • What needs to change in this regard?		✓
Consideration of the administering authority's overall approach to risk management should be a focus for LPBs. They should ask: • Does the administering authority have an appropriate mechanism for identifying key risks across all aspects of management of the fund? • Does risk reporting cover the things that we might expect given information from other sources? Examples include: internal audit reports; benchmarking data; complaints data; performance management information; changes in employer and employee profiles; the funding position and guidance from TPR and the national advisory board. • Does risk reporting indicate that the risks are being responded to and managed effectively?	✓	
Internal control and internal audit		
The LPB needs to understand the extent to which assurance is provided over the internal controls affecting the board's main risks. The board should seek assurance that this covers the whole range of activities. Given the newness of the career average scheme, an emphasis on understanding and gaining assurance over data quality controls is advisable.	✓	
Administration costs		
One focus for the LPBs should be around understanding the extent to which the administering authority: • knows the level of its administration costs, including investment management expenses • looks to achieve efficiencies in them and challenges the status quo • evaluates the impact of such measures in terms of savings achieved and quality. It will be important to recognise that there are new requirements that will result in increased costs in some aspects of the fund management.	✓	

Contact us

Head of Local Government
Paul Dossett
Partner
T 020 7728 3180
E paul.dossett@uk.gt.com

Public Sector Governance Lead
Paul Hughes
Director
T 020 7728 2256
E paul.hughes@uk.gt.com

North and Scotland
Fiona Blatcher
Associate Director
T 0161 234 6393
E fiona.c.blatcher@uk.gt.com

Midlands
Helen Lillington
Audit Manager
T 0121 232 5312
E helen.m.lillington@uk.gt.com

London and South East
Emily Hill
Associate Director
T 020 7728 3259
E emily.hill@uk.gt.com

Wales and South West
Julie Masci
Senior Manager
T 0292 034 7506
E julie.masci@uk.gt.com

Grant Thornton

grant-thornton.co.uk

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