ITEM No …10……..….

REPORT TO: **POLICY AND RESOURCES COMMITTEE – 19 NOVEMBER 2018**

REPORT ON: **REVIEW OF THE STRUCTURE OF THE SCOTTISH LOCAL GOVERNMENT PENSION SCHEME –RESPONSE BY DUNDEE CITY COUNCIL AS A PARTICIPATING EMPLOYER OF TAYSIDE PENSION FUND**

REPORT BY: **EXECUTIVE DIRECTOR OF CORPORATE SERVICES**

REPORT NO: **362-2018**

1 PURPOSE OF REPORT

To provide a draft response to a review being carried out by the Pensions Institute on behalf of the Scottish Local Government Pension Scheme Advisory Board.

2 RECOMMENDATION

The Committee is asked to:

- note the contents of this report;
- approve the response attached at Appendix A for submission to the Pensions Institute.

3 FINANCIAL IMPLICATIONS

There is no immediate financial impact arising from the report, however, depending on the outcome of the review, there could be significant financial impact on future employer contribution rates. These are referred to in the draft response.

4 BACKGROUND

The Pension Sub-Committee and Pension Board has been provided with periodic updates on a review of the structure of the Local Government Pension Scheme (LGPS) scheme in Scotland which is being carried out by the Scheme Advisory Board (SAB) at the request of the Scottish Government Cabinet Secretary for Finance and Constitution, Derek Mackay MSP. The consultation was launched during June 2018 with the deadline for response is 7th December 2018, and the SAB have commissioned the Pensions Institute to manage the consultation process.

5 CONSULTATION

The consultation was launched during June 2018 with the deadline for response is 7th December 2018, and the SAB have commissioned the Pensions Institute to manage the consultation process. Appendix B provides details on the report which launched the consultation.

5.1 Objectives

The consultation seeks to establish the views of employers and employee representative groups on whether outcomes for the members and sponsors of the Scottish Local Government Pension Scheme (SLGPS) can be improved by altering the structure of the scheme. The consultation asks these stakeholders to compare the advantages and disadvantages of the current scheme structure against three options that, by differing degrees, consolidate the functions of the scheme's 11 constituent funds by collaboration, pooling and merger. The consultation has been limited to the two stakeholder groups. No specialist advisors or investment managers are permitted to provide response.

5.2 **Options**

The 4 options identified in the Consultation Report are:

- retain the current structure with 11 funds
- promote cooperation in investing and administration between the 11 funds
- pool investments between the 11 funds
- merge the 11 funds into one or more funds.

The consultation focuses on 4 criteria in relation to each option.

5.3 **Criteria**

The 4 criteria against which each of the options is to be assessed are:

- cost of investing
- governance
- operating risks
- infrastructure investment

6 POLICY IMPLICATIONS

This Report has been screened for any policy implications in respect of Sustainability, Strategic Environmental Assessment, Anti-Poverty, Equality Impact Assessment and Risk Management.

There are no major issues, however whilst there is no immediate legal impact, the review could require amendment to regulations and legislation.

7 CONSULTATION

The Council Management Team have been consulted in the preparation of this report.

8 BACKGROUND PAPERS

None

GREGORY COLGAN
EXECUTIVE DIRECTOR OF CORPORATE SERVICES **8 NOVEMBER 2018**

APPENDIX A

Review of the Structure of the Scottish Local Government Pension Scheme

CONSULTATION RESPONSE FORM

Instructions
Responses in this form should be drafted in conjunction with the accompanying consultation report. To respond, please complete the **respondent details** and as many of the **consultation questions** your organisation wishes to complete and return the form via email to the Pensions Institute at consultation@pensions-intitute.org no later than **Friday, 7 December 2018**.

This consultation is being conducted in electronic form only, so **responses must be emailed**; hard copy posted or delivered responses cannot be received. Any queries about the consultation should be addressed to Matthew Roy, Fellow, Pensions Institute at matthew.roy@pensions-institute.org.

RESPONDENT DETAILS

Name of responding organisation(s) Please list the full name of each organisation participating in this response.	**Organisation type** Is your organisation an administering authority, employer, or employee group? Please record for each responding organisation.
Dundee City Council	Participating Employer of Tayside Pension Fund

Authors Please list any people that wish to be recorded as authors of this response, including name, job title and organisation.	**Consent** Please confirm each author consents to their information being retained for analysing the consultation responses by writing 'confirm' by their name.
Gregory Colgan, Executive Director of Corporate Services	confirm

Date	date

Please date the response.

Covering information

If you wish to include covering information with your response, please include the text here. The text can wrap onto additional pages if needed.

Dundee City Council is the administering authority and a participating employer of Tayside Pension Fund.

See below for key information about Tayside Pension Fund as at 30th June 2018:

Membership	Active Members: 19,004 Deferred Members: 13,442 Pensioners: 15,786 **Total Membership: 48,232**
No. Employers	46
Portfolio Value	£3.87bn
Investment Performance	3yr: 11.6% p.a. 5yr: 11.37% p.a. 10yr: 9.3% p.a. Investments have out-performed benchmarks in all time periods above.
Funding	Estimated funding level (assets / liabilities) 107% (net of 10% volatility reserve).
Employer Contribution Rate	17% since April 2014 (reduced from 18%)

See next page the key information about Dundee City Council as an employer as at 31st March 2018:

Member data summary	Number	Salaries/Pensions £000s	Average age
Actives	5,468	126,458	47
Deferred pensioners	3,046	5,593	47
Pensioners	5,413	29,496	71
Unfunded pensioners	1,303	2,557	72

The consultation questions follow.

CONSULTATION QUESTIONS

Question 1: Retain the current structure with 11 funds

The text can wrap onto additional pages.

a) Cost of investing:

How well informed do you feel about the investment costs in your fund? What information do you rely on to specify and measure these?

As the officers and Pensions Sub-Committee Members are employed DCC or are DCC elected members, the Council feel that we have a full understanding and are well informed about the investment costs of the fund.

Perhaps an easy measure for any employer to assess the costs being incurred within the fund is that of the level of contribution they are being asked to pay as if this is low, then they can be reassured that both returns are adequate and costs are controlled. To this, DCC is comfortable with having the 2nd lowest contribution rate within the Scottish LGPS at 17%.

Dundee City Council (DCC) is comfortable that Tayside Pension Fund (TPF) have complied with CIPFA guidance on accounting for Local Government Pension Scheme Management Expenses.

Whilst admittedly TPF have little / no complex asset classes or products that are accused of having “hidden costs”, all investment management costs are recognised, measured and disclosed in the Fund Account in line with the guidance, therefore for the products within the TPF portfolio, we are comfortable with the level of knowledge of fund costs.

Whilst the annual investment reviews are undertaken independently (that assess fee levels) are not within the public realm, DCC is represented within the Committee who have sight of the information and have opportunity to challenge if fees are not in line with peers or industry average. Furthermore, at employers forums, the fund officers provide presentation on fund performance and costs.

How well does the current system manage investment costs?

The Scheme Advisory Board (SAB) structural review report refers to The Financial Conduct Authority's (FCA) recent Asset Management Market Study, which highlights a number of weaknesses in the current asset management system in the UK. These include weak price competition, a lack of transparency, and a lack of alignment of fees and performance. DCC believe that these issues apply particularly to small, retail investors, and as Local Government Pension Scheme (LGPS) funds are all large investors, are reassured that the report confirmed are able to negotiate very effectively and get good value for money.

Whilst there is always room for improvement, it is clear that LGPS are subject to greater levels of scrutiny and transparency to their corporate counterparts. All LGPS investment services are subject to tender, and in addition to the requirements to meet public sector procurement guidance, there is additional scrutiny through the governance framework and public accountability from members and employers through the closeness to the funds that they are stakeholders in.

How would you improve the measurement and management of investment costs in the current system?

The introduction of the Transparency Code, MiFID II (the Markets in financial Instruments Directive) and other market initiatives have improved measurement and management, however these have been recent and in cases only considered best practice.

As a participating employer within TPF, DCC would support mandatory compliance with all relevant codes of practice and initiatives where applicable to the relevant asset classes in order to ensure consistency and transparency.

b) Governance:

How well informed do you feel about the governance of your fund? What information do you rely on to measure this?

TPF is administered by Dundee City Council as the administering authority with responsibility for the management of the fund delegated to the Tayside Pension Sub-Committee. This Sub-Committee meets quarterly and oversees the supervision and administration of the fund's investments, sets the investment strategy and also oversees pension administration. The day to day operational matters are further delegated in the main to the Executive Director of Corporate Services. This governance structure includes all the mandatory elements introduced by the Public Service Pensions Act 2013.

As a result of further legislative changes to the governance arrangements in relation to pension schemes within the public sector, The Pension Board was established on 1st April 2015 and is separate from the Pension Sub-Committee. The Pension Board are responsible for assisting in securing compliance with the regulation and other legislation relating to the governance and administration of the Scheme and also the requirements of the Pensions Regulator.

The role of the Pension Board is to assist TPF in complying with all of the legislative requirements and making sure that the scheme is being efficiently & effectively governed and managed.

The Pension Board members work in conjunction with the officers of TPF to ensure DCC that the pension scheme is well managed and administered, and that scheme members get the best service. The local Pension Board must have an equal number of scheme member and scheme employer representatives and board members are appointed for a term of 5 years (in line with local government election cycle).

In light of the above, DCC is comfortable that TPF has appropriate governance statements and policies in place which are available within a defined area of the TPF website as well as within the annual report of the fund.

DCC is comfortable with the level of effectiveness of TPF's governance as it is measured annually by external auditors. Audit Scotland has reported within their own annual audit report that TPF has effective governance arrangements in place that support scrutiny of decisions made by the Pension Sub-committee. Furthermore, DCC is reassured that decisions are transparent with committee papers and detailed minutes of meetings of the Pension Sub-committee available on the Dundee City Council's website and all policies and strategies available on the TPF website.

How well is the current system governed?

DCC is aware that the current system of governance in the Scottish LGPS was only recently introduced - in 2015. It was the result of extensive review by a UK government commission leading to primary legislation and new scheme regulations.

In 2016, the Scottish Public Pensions Agency (SPPA) commissioned KPMG to undertake a review of the arrangements. The review's findings overall were positive and no fundamental weaknesses were identified, although KPMG made a number of recommendations aimed at helping the new Boards establish their purpose.

All boards are now in place, and although DCC would not wish to comment on other funds governance arrangements, DCC believe that TPF has a strong governance structure which is not overly complex. This governance not only applies to investment, but to the overall management of the scheme and ensures accountability for all aspects of pension fund management. DCC is confident that TPF are adequately resourced, and the broad representation of skills and knowledge across the Officers, Committee and the Board ensures appropriate challenge and accountability for decision making and performance monitoring and management. Specialist independent advisors ensure effectiveness and efficiency.

Whilst DCC is aware that it has been stated that those involved in the governance and administration of funds have vested interests due to potential adverse effects of any structure change, DCC believe that the focus should remain primarily on the members and employers of the fund as it is also stated that changes to the structure could affect employers directly, with contributions levels being impacted by changed investment returns as a result of having a change of strategy imposed, or indeed, a change of management, which has poorer performance than they have benefited from in the past. DCC is concerned that some employers may not be able to accommodate any rise in contribution rates, and whilst a change in structure should not affect member's benefits directly, if investment returns are significantly lower, this may occur (as has been the case for the University Superannuation Scheme).

DCC is aware that some believe the governance of the SLGPS to be inefficient, due to the volumes of people across the country involved in the Pensions Committee and Pension Boards, but believe that this was the structure designed by the UK Government to support close ties with stakeholders, and although admittedly some of the people involved at the beginning had limited knowledge and experience of pension matters, the officers, advisors and experienced members of Committees have provided support and guidance. DCC believe that the introduction of pensions boards in addition to pension committees has improved the scrutiny and communication of the fund with its stakeholders.

DCC is aware that statements have been made regarding Councils acting as Administering Authorities bring governance issues including limited involvement of stakeholders and conflicts of interest for both officer and elected members. DCC believe that there is no evidence of this and furthermore believe that TPF (as well as all other Scottish funds) have appropriate policies and controls in place to prevent this.

How would you improve governance of the current system?

DCC believe that recommendations from the KPMG review should continue to be worked through and implemented.

Whilst each fund is subject to scrutiny through its own governance and audit, some believe that there is a lack of consistency of information which makes it difficult for stakeholders to judge the effectiveness of their fund, and of the Scheme as a whole. These concerns have been addressed by the recent initiatives such as the LGPS Transparency Code, introduction of Pensions Boards and increased collaboration and co-investment between funds which is helping to further improve governance and manage costs. DCC's recommendation would be that these measures should be allowed time to be incorporated into standard operating practice prior to making further assessment or recommendation in this area.

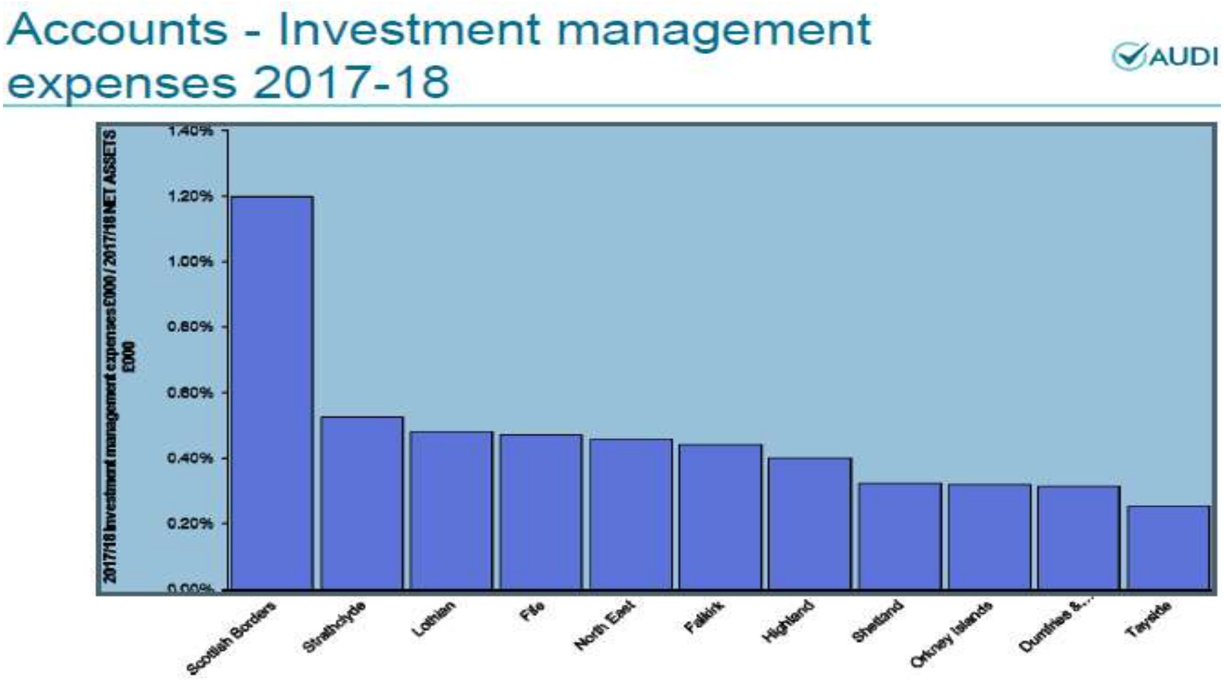
How important is it to maintain a local connection with respect to oversight and strategy?

DCC believe that the LGPS represents both significant benefit for scheme members, but also considerable cost for employers. Local connection is essential to ensure that both employers and members can exercise meaningful oversight, and that investment and funding strategies are fully aligned and tailored to their own membership requirements. DCC believe that the closeness to its stakeholders has had positive impact on the performance of the fund overall as the closeness to the employers and membership enables face to face communication and better understanding of local circumstances.

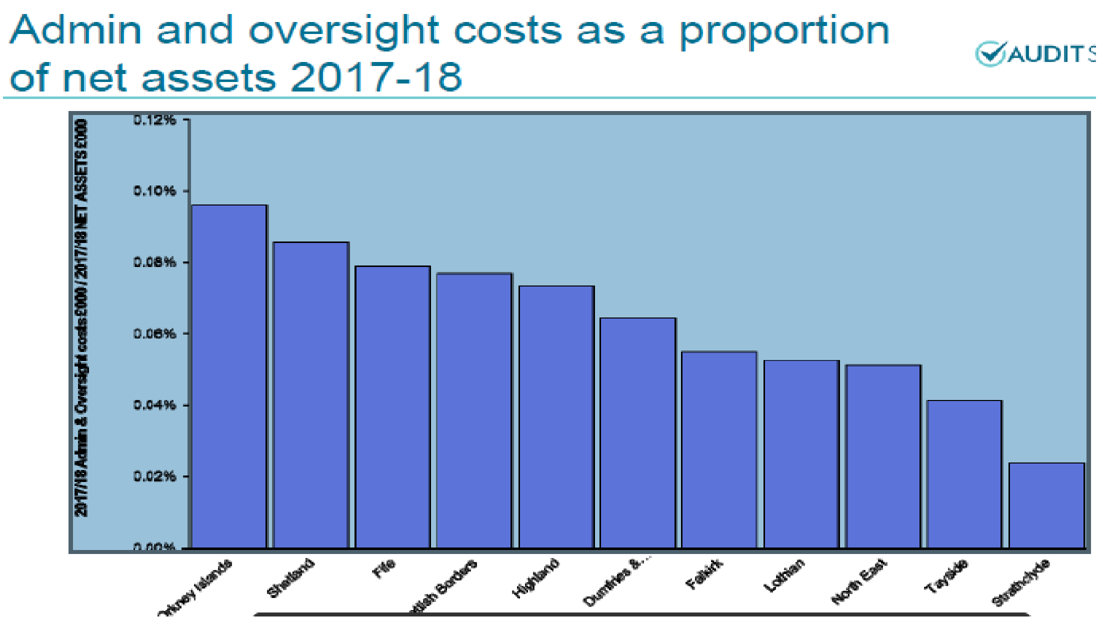
How would you determine if the benefits of a local connection in governance outweigh the benefits of scale?

DCC believe that there is absolutely no evidence to suggest that the current model is fundamentally flawed. Indeed, the LGPS in Scotland is a considerable success story.

DCC believe that TPF already enjoys considerable benefits of scale in terms of cost at a value of almost £4bn. This is demonstrated by the independent annual reviews undertaken by Audit Scotland with the lowest investment management expenses regardless of size:



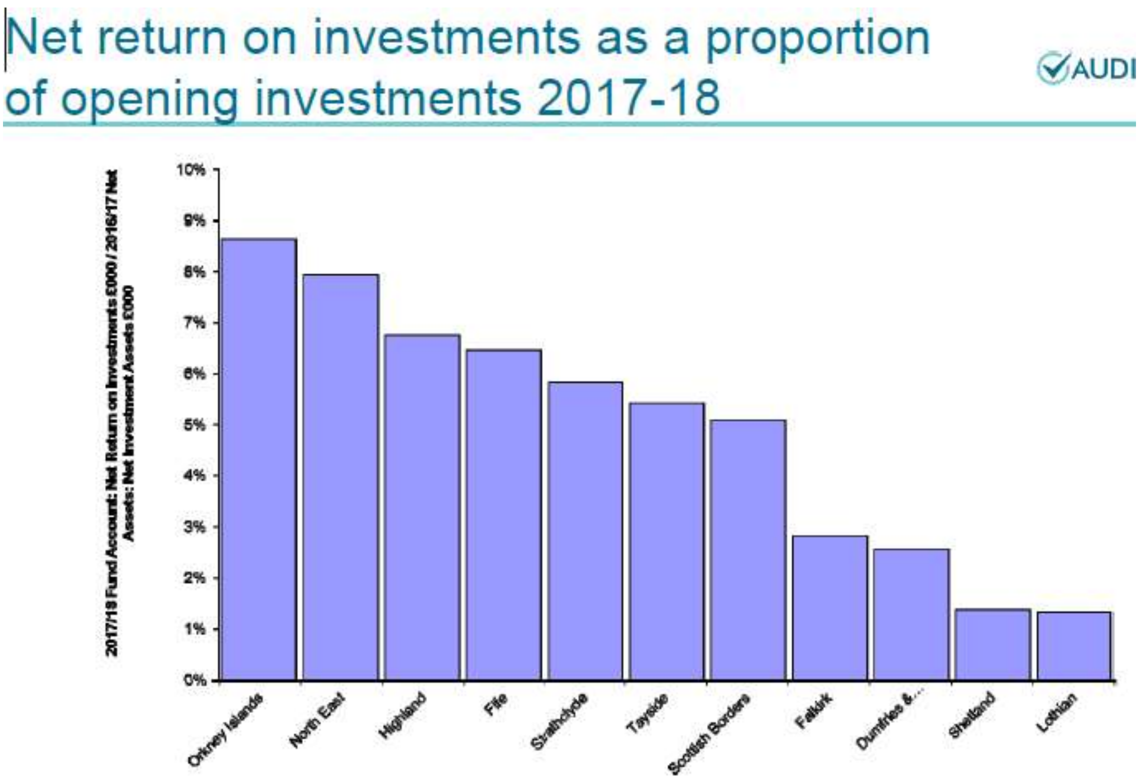
Furthermore TPF have the second lowest administration and oversight costs as proportion of net assets. DCC believe that the local scrutiny and accountability are crucial in maintaining value for money.



Whilst there are various figures being quoted in way of potential savings in investment management costs that would be achieved by merging into one large fund, these figures are assuming internal investment management, but do not provide insight as to impact on investment returns.

In terms of administration and oversight, there is no huge correlation as to economies of scale that would have such an impact as to warrant fund merger.

In 2017/18, the following performance across funds was captured by Audit Scotland. From this we can see that there are a range of returns, but these are in no way correlated to in-house, or larger schemes.



c) Operating risks:

How well informed do feel about the operating risks of your fund? What information do you rely on to specify and measure these?

As an employer, DCC is aware that TPF have a detailed risk register which is subject to continual appraisal and quarterly review by the TPF Sub-Committee and Board. The risk register is publicly available both on the TPF website and within the minutes of the meetings on Dundee City Council website. The full risk register is also published within the Annual Report.

Whilst it is mooted that there are key person risk within smaller funds, DCC believe TPF to have sound and solid governance in place to ensure that there is adequate speciailist resource available to assist if required, whether it be by senior officer, investment advisor or from support and guidance in the short term from other funds.

How well are operating risks managed in the current system?

As noted above, DCC believe TPF to have a strong focus on the identification, analysis and management of risk. Employers are aware of the Investment and funding strategies that are designed to manage specific risks, and that there are controls built into processes to ensure that risks are managed appropriately and proportionately.

DCC as participating employers, are aware of the risk monitoring with investment managers (who are contractually bound to have robust compliance and risk management resource) is undertaken quarterly, and external analysis is also undertaken by investment consultants and auditors.

DCC believe that having 11 funds in operation with differing investment strategies provides suitable diversification and risk management for the Scottish LGPS and the employers within. DCC believe that the greater the fund size, the harder the task of diversification and thus the increase of risk to the membership of the fund. This is a key point that managers of larger, successful funds point out as once too big the risk of diseconomies of scale grows as the bigger the fund, the more inflexible it is to manage.

How would you improve the measurement and management of operating risks in the current system?

DCC believe that scheme benefits and the application of these are a key area which could benefit from improvement. The regulations associated with scheme benefits have over the years become more and more complex. At present there are in effect 3 benefit schemes in operation ($1/80^{th}$, $1/60^{th}$, $1/49^{th}$) as well as numerous administering body and employer discretions available through the differing regulations. This complexity significantly increases operating risks associated with administering benefits.

The introduction of the cost cap which may result in further change to benefit regime will only complicate this further. DCC would support any means of simplification of LGPS benefits and discretions to enable greater standardisation in administration and thus better management of risk.

d) Infrastructure:

How well informed do you feel about your fund's investments in infrastructure? What information do you rely on?

DCC is aware that TPF have ability within investment strategy to allocate 10% of fund to local and alternative opportunities, of which infrastructure forms part of. DCC is also aware that TPF have engaged KPMG (TPF investment advisors) to assess market conditions in line with the risk and return profile and requirements of the fund to develop a bespoke strategy to progress investment within this broader asset class.

How do you rate the current system's ability to invest in infrastructure?

DCC believe that infrastructure investment requires a sound understanding of risk, return and governance characteristics. In terms of size, DCC is aware that TPF are not constrained as big enough to support large scale investment, but are aware that infrastructure is relatively illiquid, supply-constrained and expensive, so believe that care and caution must be exercised.

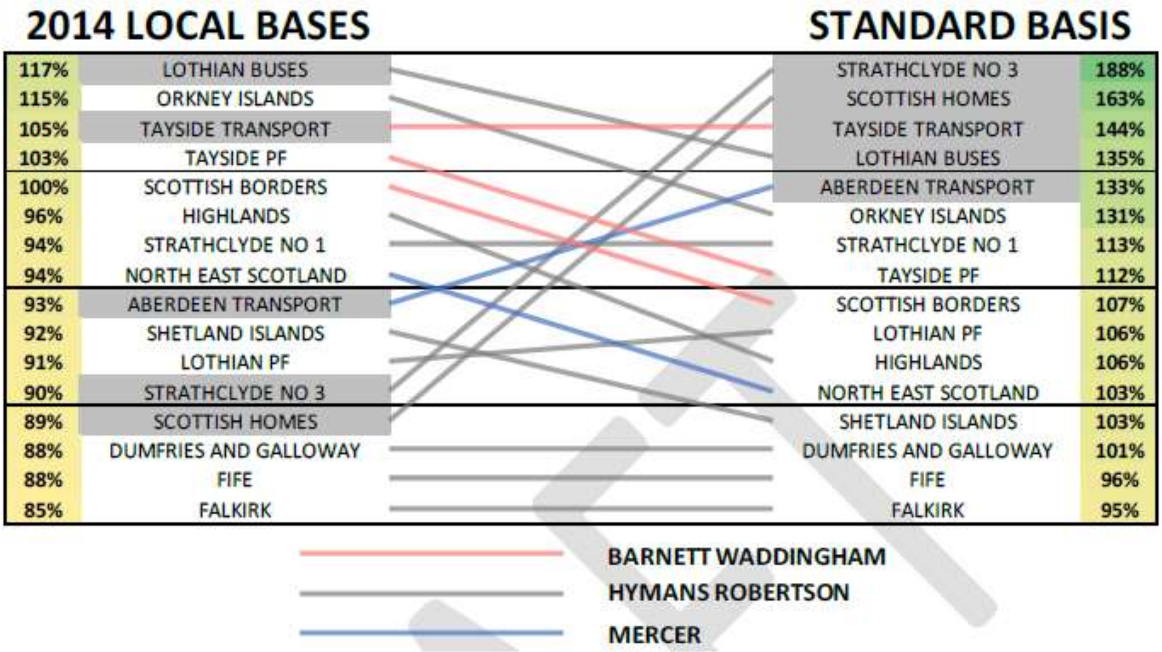
How would you increase investment in infrastructure in the current system?

DCC believe that investment in infrastructure could increase if the supply of attractive opportunities increased, or the risk/return characteristics were improved. More simple investment structures would also assist.

e) Do you have any additional comments about this option?

DCC believe that it is worth re-iterating that the LGPS in Scotland is a success story. Funds have solid and stable management and their closeness to their own stakeholders has enabled investment strategies to be tailored to the needs of individual funds in meeting their liabilities.

The Scottish funds are all close to or above 100% funded meaning that their primary objective has been achieved. The LGPS in Scotland has for very many years been better funded than its equivalent in England and the rest of the UK. The Government Actuary Department's (GAD) Section 13 report analysed all Scottish funds on a standard basis demonstrates this strong position, but also that fund's don't necessarily have to be big to be successful. The following graph over the page by GAD provides further



evidence.

DCC do not believe that the evidence above is in line with implications that the Scottish local government pension scheme is not well managed, or providing value for money.

DCC believe that Funds will need to adapt to address the challenges identified within the Scheme Advisory Board report, but these challenges do not stem from the current structure, and revising the structure is unlikely to be a panacea for them.

Question 2: Promote cooperation in investing and administration between the 11 funds

The text can wrap onto additional pages.

a) Cost of investing:

What impact do you think promoting agreements between funds would have on investment costs?

DCC think that this is potentially the largest area that could deliver improvements both in terms of costs and in quality of performance.

What would be the positive impacts?

- Financial savings (fees and services)
- Better information to facilitate more informed decision making

- Reduced resource requirements across all funds

What would be the negative impacts?

None.

b) Governance:

What impact do you think promoting agreements between funds would have on governance?

No significant impact on individual governance structures, but may lead to better outcomes.

What would be the positive impacts?

Reduced duplication of governance effort. Improved collective governance of the scheme, creating a more collaborative culture across funds.

What would be the negative impacts?

No negative impacts, but the need to co-ordinate activity and decision-making could be a complication until such arrangements bed down.

c) Operating risks:

What impact do you think promoting agreements between funds would have on operating risks?

None

What would be the positive impacts?

Could have positive impact in relation to managing risks across the funds.

What would be the negative impacts?

None

Infrastructure:

What impact do you think promoting agreements between funds would have on funds' ability to invest in infrastructure?

- Ability for funds without experience in alternative asset classes to benefit from the experience and expertise of others.
- Reduced costs of legal, consultancy and due diligence required.
- Standardised and potentially better quality information to facilitate more informed, and better decision making

What would be the positive impacts?

Potential financial savings, and facilitating wider diversification across asset classes

What would be the negative impacts?

None

d) Do you have any additional comments about this option?

DCC is aware that there is already significant co-operation between the Scottish funds and that a wider LGPS network already exists.

DCC is aware that the LGPS (UK) National Frameworks in place are widely used for a range of services including actuarial, investment consultancy, stewardship, global custody, performance and cost monitoring, legal, transition management and third party administration services.

DCC is also aware of Scottish LGPS framework agreements that have been put in place for portfolio management, member tracing, and scheme administration, and that the introduction of LGPS 2015, and the associated member and employer communications, was a large-scale collaborative exercise between all the Scottish funds.

DCC however believe that there is undoubtedly scope and willingness to build further on these initiatives.

Question 3: Pool investments between the 11 funds

The text can wrap onto additional pages.

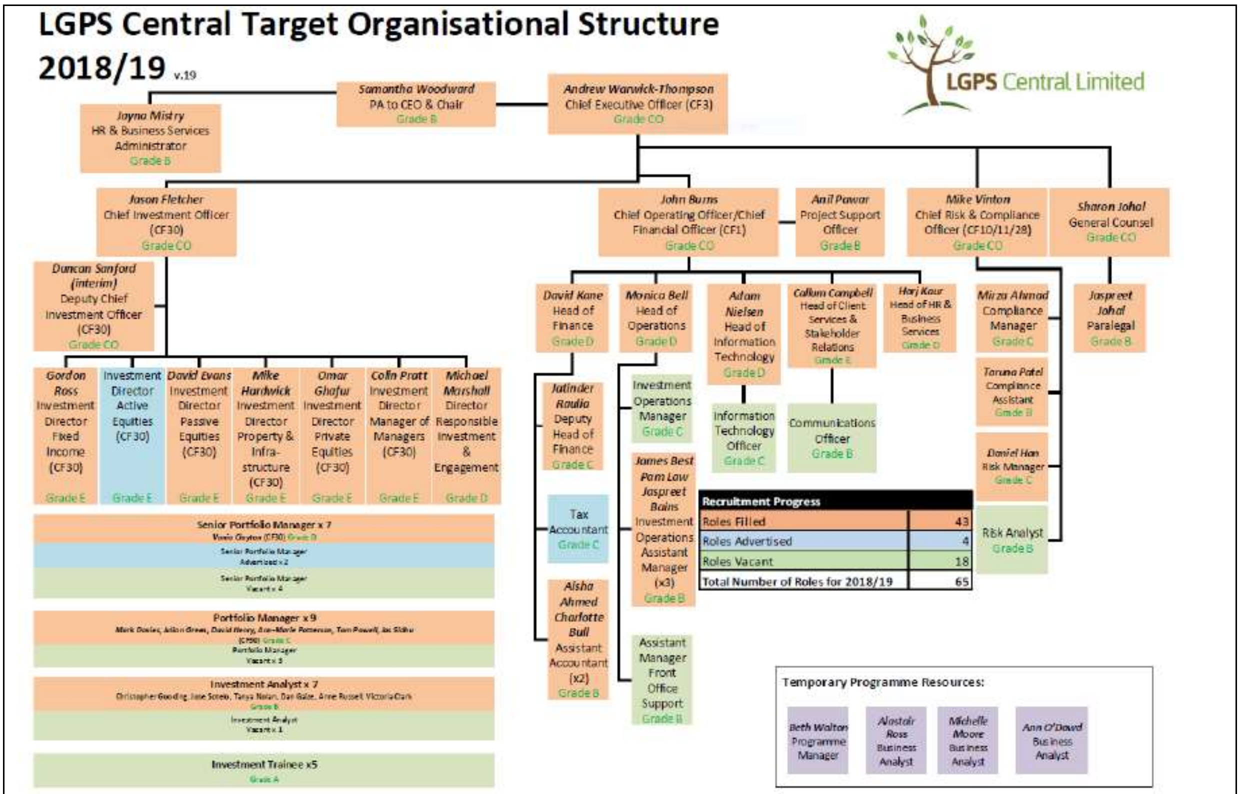
a) Cost of investing:

What impact do you think pooling investments between funds would have on the cost of investing?

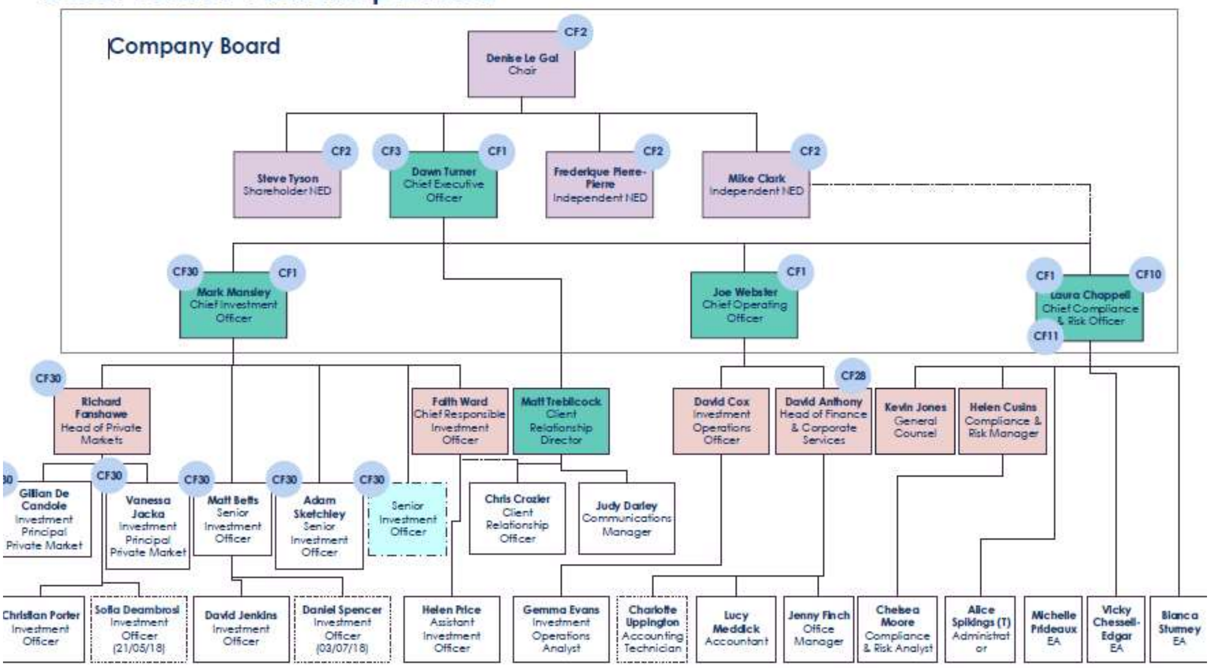
DCC is aware that TPF already enjoys significant benefits of scale and is very effective in ensuring lowest cost investment fees as demonstrated in independent assessments by Audit Scotland, therefore DCC believe that further efficiencies in existing mandates are unlikely to be achieved through adding further scale. DCC is of the opinion that pooling would be detrimental to the TPF investment strategy as it would result in limiting the ability to meet investment objectives. Investment mandates are specifically selected in order to complement each other with the aims of achieving the required investment objectives to provide adequate returns (at an acceptable level of risk) to meet the overall TPF pension liabilities.

DCC believe that there would be an additional layer of bureaucracy and cost, as well as a loss in ability to make the optimal investment decisions for the benefit of the funds members and employers. This could have significant impact on the level of contributions that are currently paid, therefore increasing the cost to employer. The lower the contribution, the more reassurance that employers have both returns are adequate and costs are controlled. To this, DCC is comfortable with having the 2nd lowest contribution rate within the Scottish LGPS at 17%.

The complex pool structures in England and Wales demonstrate this additional bureaucracy and costs:



Brunel Pension Partnership Limited



What would be the positive impacts?

DCC believe any positive impacts to be unlikely, but believe the costs to be significant.

What would be the negative impacts?

DCC believe that reducing cost is only a positive impact if it improves net returns, and there is no evidence that costs have actually been reduced in England and Wales. Cost reduction through pooling would be a negative if it led to a restricted choice of investment options, and reduced returns or increased risk.

DCC believe the ultimate negative impact would be when restricted choice led to reduced returns and failure to best meet the investment objectives of the funds members and employers, and there was a detrimental impact on the funding level and subsequently on employer contribution.

The risk that employers may not be able to accommodate any rise in contribution rates, and whilst a change in structure should not affect members benefits directly, if investment returns are significantly lower, this may occur (as has been the case for the University Superannuation Scheme).

If asset pooling were possible, under what circumstances should a fund consider joining an asset pool?

DCC believe that a fund should only be embarking upon this arrangement if stakeholders unanimously believed that the decision to pool is in the best interests of their members to whom they have fiduciary duty to act in their best interest. DCC do not believe that pooling would be in the best interest of their members.

Under which circumstances should the SLGPS consider directing funds to pool?

DCC believe that pooling should be considered if there was clear evidence that funds were unable to manage and failed to meet their investment objectives and there was potential for detrimental impact to members and employers.

b) Governance:

What impact do you think pooling investments between funds would have on governance?

Where pools oversee external investment managers, this represents an additional layer of governance between the fund and the manager. DCC believe that this is likely to reduce transparency and complicate governance (see organizational charts of the large complex structures in place in England and Wales above).

Also, where pools manage investments internally, DCC believe that the funds may become captive – i.e. it would be difficult to replace the internal management team if they underperformed.

What would be the positive impacts?

DCC do not consider there to be any potential positive impacts.

What would be the negative impacts?

- Cost of set up and maintenance
- Resource to establish and maintain
- Loss of flexibility which could have negative impact in meeting objectives and ultimately in costing more to employers / and member benefits

c) Operating risks:

What impact do you think pooling investments between funds would have on operating risks?

- Pools with external managed funds - Potentially increased operating risks as there would be the existing operating risks of the managers, but then a new layer of risks associated with management of the pool.

- Pools with internally managed funds – Increased risk management and compliance resources would be required to enable comparative effectiveness with external management (who are managing considerably more funds than LGPS, and have global resources and expertise to do so).

What would be the positive impacts?

DCC do not consider there to be any potential positive impacts.

What would be the negative impacts?

- Financial cost

- Detrimental impact on resources

- Concentration of risk

d) Infrastructure:

What impact do you think pooling investments between funds would have on funds' ability to invest in infrastructure?

DCC believe there to be very little impact, if any. Varying sized funds invest in infrastructure, it largely depends on the fund's choice of investment.

DCC believe that pooling investments might facilitate infrastructure investment by funds who currently don't, but across the Scottish funds, the potential increase in allocation to this asset class would not materially change the total investment in infrastructure.

What would be the positive impacts?

DCC believe that a combined initiative by the Scottish funds to invest in infrastructure could have some merit. The recent report by the Scottish Futures Trust (SFT) on Scottish Real Asset Investments and the Local Government Pension Scheme identifies an area of investment that "enables LGPS to meet their fiduciary duties with good risk adjusted returns that are not highly sought after or competed for by other investors: as those investments are not highly competed for by other investors, investment in them will provide a level of additionality to the Scottish real asset stock, and where they relate to new developments, they will provide additional Scottish capital stock."

DCC stress though that:

- the positive impacts identified by SFT are not related to the objectives of the

LGPS and its funds; and

- it would not be necessary to pool funds in their entirety to facilitate investment in infrastructure. The creation of a pooled investment vehicle in which funds could invest would achieve this if the vehicle was sufficiently attractive on a risk/return assessment.

What would be the negative impacts?

- o Large set up costs
- o Potential FCA authorization requirement

Do you have any additional comments about this option?

DCC believe that it is much too early to judge whether the pooling initiatives of England and Wales have been successful in meeting their objectives, however what is clearly apparent that is that this has been a costly and time consuming exercise with no standardised approach or clearly planned strategy. The payback period for costs incurred is likely to span many years and it is also likely to be some time until the pools settle fully into their new structures as all pools differ in set up, structure and objectives.

DCC is aware that the pooling of England and Wales has also had detrimental impact on stripping resources from administering authorities who still require skills and resources, therefore potentially increasing risk of detrimental impact in the management of the funds.

DCC is clear in their considerations that infrastructure investment is not the primary objective of the LGPS, and thus fiduciary duty must be considered if considering pooling the funds simply to achieve more infrastructure investment in infrastructure.

DCC do not support the approach used in England and Wales, but believe that there might be some merit in more selective pooling, on a voluntary basis either of individual asset classes or by specific groups of funds, dependant on wishes of those individual funds in order to meet their requirements.

Question 4: Merge the funds into one or more new funds

The text can wrap onto additional pages.

Cost of investing:

What impact do you think mergers between funds would have on the cost of investing?

Answer as for pooling at 3.a, above.

What would be the positive impacts?

Answer as for pooling at 3.a, above.

What would be the negative impacts?

Answer as for pooling at 3.a, above, but the transitional costs would be much greater.

DCC is very aware that changes to the structure could, however, affect employers directly – their contribution rates are impacted by investment returns and funding. The potential impact of “what could happen” is demonstrated below:

Scottish LGPS Contribution Rates	
Dumfries & Galloway	25.87%
Fife	23.72%
Falkirk	23.39%
Lothian	23.10%
Shetland	20.72%
Highlands	20.20%
Strathclyde	19.30%
Scottish Borders	18.00%
North East Scotland	17.50%
Tayside	17.00%
Orkney	15.20%

Scottish LGPS Local Funding Versus Standard Rates		
Dumfries & Galloway	88.00%	101.00%
Fife	88.00%	96.00%
Falkirk	88.00%	95.00%
Lothian	91.00%	106.00%
Shetland	92.00%	103.00%
Highlands	96.00%	106.00%
Strathclyde	90.00%	113.00%
Scottish Borders	100.00%	107.00%
North East Scotland	94.00%	103.00%
Tayside	103.00%	112.00%
Orkney	115.00%	131.00%

Some fund employers would not be able to accommodate change to contribution rates, furthermore, and as this increased contribution would be as a result as a drop in funding level, this would not be in the best interest of the scheme membership.

In light of the above risks, DCC could not support any option which could result in an increase in contribution rates which would be unaffordable. A 1% increase in employer contribution level would result in an estimated increase in pension costs of £4m for Dundee City Council.

If merging were possible, under what circumstances should a fund consider a merger?

DCC believe that any fund merger should only be considered if 2 or more individual funds (and their stakeholders) believe this option to be in the best interests of their members and employers.

Under what circumstances should the SLGPS consider directing funds to merge?

Answer as for pooling at 3.a, above.

Governance:

What impact do you think mergers between funds would have on governance?

DCC believe that a merger would inevitably reduce or remove local involvement in pension fund governance which is believed to be intrinsic to the successful performance of TPF. The degree of this would depend on the model and extent of the merger.

What would be the positive impacts?

DCC believe that whilst a merged model would require less governance resource than individual governance models, this is only truly a positive if the merged model is proven to be more effective.

What would be the negative impacts?

DCC believe that a merged model would increase the reliance on a smaller number of individuals, and in so, significant increase in risk.

Operating risks:

What impact do you think mergers between funds would have on operating risks?

DCC believe that a fund merger would inevitably result in concentration of risk, and reduced diversification. However, if 2 or more funds did believe merger to be beneficial for their individual circumstances, this should still be a key consideration for them, but them in isolation.

DCC believe that whilst there are opinions of the potential savings a full merger of Scottish funds might may have, it may be worth noting that there has been no balance in assessing the impact of potential failure on the collective membership and employers due to the decisions of a reduced number of individuals. DCC do not consider size as a guarantee of success, and the impact of failure would be catastrophic for the country.

What would be the positive impacts?

DCC do not consider there to be any potential positive impacts.

What would be the negative impacts?

- Concentration of risk.
- Impact of failings
- Loss of flexibility
- Reliance on a reduced number of people

Infrastructure:

What impact do you think mergers between funds would have on funds' ability to invest in infrastructure?

DCC believe that a full merger of Scottish funds could increase investment in infrastructure, but only if the investment strategy required this. Investment strategies are set to meet risk and return objectives, not to facilitate an investment in a favoured asset class.

- What would be the positive impacts?

DCC believe that a merged fund or funds could potentially make larger individual infrastructure investments.

What would be the negative impacts?

DCC believe that larger individual investments would represent a greater concentration of risk.

Do you have any additional comments about this option?

DCC is of the opinion that a merger into one fund would be likely to break the direct link between the scheme and local government by taking the fund out of local government control; and whilst a fund of this size would undoubtedly enjoy some benefits of scale (in certain asset classes), size is not a guarantor, nor necessarily a determinant of success.

The UK's 2 largest pension funds are the Universities Superannuation Scheme (USS) and the British Telecom Pension Scheme (BTPS). Both have assets of around £50 billion (a little more than the combined value of the Scottish LGPS funds). Both are very well managed in many respects. Yet both have significant funding deficits – in excess of £10 billion in each case – and are contemplating, or have effected closure of their schemes to new defined benefit accrual.

Question 5: Preferred and additional options

The text can wrap onto additional pages.

a) Which option does your organisation prefer? Please explain your preference.

DCC is of the opinion that TPF already enjoys considerable benefits of scale in terms of cost which is demonstrated by the independent annual reviews undertaken by Audit Scotland.

DCC is comfortable that TPF has in place an appropriate and effective governance structure and risk management processes.

DCC do not believe that it is clear what would be gained by members or employers from the proposed alternative models of pooled or merged funds. It is certain, though, that there would be significant costs and risks associated with any change, and any pooling or merger of funds should only occur where individual funds are in agreement that this would be to the benefit of their members and employers.

DCC is patently aware that TPF has a low contribution rate which is based upon the localised asset and liability profile of the fund, its underlying funding position and bespoke investment strategy, and whilst protection would be sought to retain this should the pooling or merger option be chosen as the optimal structure, there is no guarantee that any future investment strategy determined at larger scale would sustain this. The risks that a change of structure that could result in a rise in employer contribution rates, and in turn a potential change in benefits would not be supported by DCC as this would not be in the best interest of the scheme membership. DCC believe pension provision to be a very long-term undertaking, and that any structural development should be clearly focused on the long-term sustainability.

DCC as an employer support TPF's preferred option to develop a more collaborative structure (option 2) which could generate advantages across all funds without disruption, transitional cost and likely unintended consequences that merging or pooling would produce.

DCC is aware the Scottish LGPS has established communications networks between funds (both investment and administration), but that the current focus is largely on information sharing and problem-solving rather than structural development. DCC would support TPF in welcoming the opportunity to collaborate in areas such as investment opportunities; procurement; ESG & governance issues; administration.

b) What other options should be considered for the future structure of the LGPS?

DCC believe that collaborative initiatives might include the following:

- development of a forward-looking programme to consider potential initiatives such as:
    - joint investment, including in infrastructure
    - joint or framework procurement
    - joint or shared diligence
- joint engagement on environmental, social or governance issues
- shared communications and administration (e.g. GMP) where applicable.
- a regular, formalised meeting of fund conveners

c) What would be the advantages and disadvantages of these other option for funds' investment costs, governance, operating risks and ability to invest in infrastructure?

DCC believe that the development of collaborative base as suggested above, could generate many of the advantages of the individual options identified without the disruption, transitional cost and likely unintended consequences that selecting and mandating one option would produce.

d) Are there any other comments you would like to make?

DCC believe that pension provision is a very long-term undertaking, and the prime objective is to act in the best interest of the members in order to meet their requirements, therefore any structural change should be clearly strategically focused on the long-term benefits of the members rather than any external objectives.

DCC believe that a fund should only be embarking upon arrangement to pool or merge if stakeholders unanimously believe that the decision is in the best interests of their members to whom they have fiduciary duty to act in their best interest. DCC do not believe that pooling or merging would be in the best interest of their members.

DCC is very aware that changes to the structure could, however, affect employers directly – their contribution rates are impacted by investment returns and funding. Some fund employers would not be able to accommodate change to contribution rates, furthermore, and which would be as a result as a drop in funding level would not be in the best interest of the scheme membership.

In light of the above risks, DCC could not support any option which could result in an increase in contribution rates which would be unaffordable.

The consultation questions end.

APPENDIX B

Consultation on the

Review of the Structure of the Scottish Local Government Pension Fund

Carried out by the Pensions Institute

on behalf of the Scottish Local Government Pension Scheme Advisory Board

June 2018

Contents

About the Pensions Institute

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

About the Scheme Advisory Board

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

Cabinet Secretary's foreword

I am delighted to support the launch of the Scottish Local Government Pension Scheme Advisory Board's consultation on a structural review of the Local Government Pension Scheme (LGPS) pension funds in Scotland.

LGPS fund authorities invest in a wide variety of projects including local housing and infrastructure, however investment in Scotland's infrastructure is only a small part of the investment strategy of the Scottish fund authorities. The Scottish Government is ambitious for greater investment by local government funds in Scotland's infrastructure.

There are currently excellent examples of fund authorities collaborating on infrastructure projects in Scotland. We look to LGPS fund authorities to improve their already positive impact on the economy thereby contributing further to sustainable economic growth, creating more jobs and supporting the delivery of key capital infrastructure needs in Scotland, such as transport projects and housing.

A key part of the Scheme Advisory Board's role is to provide advice about the effective and efficient administration and management of the Scheme. So I asked the board to investigate the collaboration between fund authorities to invest in Scottish infrastructure, whilst maintaining overall investment performance to ensure that the interests of LGPS members' are protected.

The Scheme Advisory Board commissioned reports from pension consultants Mercers and Iain Clacher of the University of Leeds on possible future structures for the funds. The reports highlight that the new governance arrangements require a greater focus on cost transparency and performance. The academic evidence on costs and fees also seems to support the premise that there are cost savings available with economies of scale for both the administration and investment of pension funds.

I welcome the Scheme Advisory Board's consultation, which provides four clear options for the future structure of pension funds in Scotland. I encourage you to participate fully in this important debate which could have a wide-ranging impact on the people of Scotland.

Derek Mackay MSP

Cabinet Secretary for Finance and the Constitution

Executive summary

This consultation seeks to establish the views of employers and employee representative groups on whether outcomes for the members and sponsors of the Scottish Local Government Pension Scheme (SLGPS) can be improved by altering the structure of the scheme.

The consultation asks these stakeholders to compare the advantages and disadvantages of the current scheme structure against three options that, by differing degrees, consolidate the functions of the scheme's 11 constituent funds by collaboration, pooling and merger.

The main question is whether the sustainability of the scheme, and thus members interests, can be improved by reducing the investment management costs of the system with the trade-off of potentially diminishing local governance and oversight.

Investment management costs are the single biggest line item of expenditure in the system and small reductions in fees can lead to significantly improved net investment performance for funds over the long run. But how do these quantitative gains compare to the qualitative losses of local control?

This central question also gives rise to subsidiary questions. Consolidation has the potential to improve the ability of funds to invest. Larger scale in funds could improve governance, the range of investments available to funds and the management of operating risks – each with the potential to enhance performance.

But at the same time, the roles of people working locally in funds could be diminished, with their responsibilities concentrated in a smaller set of larger funds. Changes to the current structure would generate set up costs and require careful implementation to ensure accountability was maintained.

The purpose of the consultation is to get feedback on four possible options, ranging from maintaining the *status quo* to full consolidation into one or more larger funds. Responses gathered in this consultation will be evaluated and presented to Scottish Government Ministers in 2019 for a decision on a future course of action.

Although this consultation asks questions about a potential future structure for the SLGPS, these questions were also relevant when designing the current system. This consultation asks whether the trade-off – between scaling up to reduce investment costs or retaining governance locally – inherent in the current system of 11 funds is the best interest of members and sponsors or should be revisited.

Introduction

This consultation invites employers and employee representative groups to give their views on how the Scottish Local Government Pension Scheme (SLGPS) should best be structured to serve its members and sponsors.

SLGPS is Scotland's largest pension scheme with currently more than 406,000 members who are employees, former employees and pensioners. It has members in local government, education, the police, the voluntary sector, environment agencies and private contractors. The scheme is composed of 11 individual funds with assets totalling around £42bn and liabilities to members of £55bn.[1] Each fund serves a different group of employer organisations, the largest fund is Strathclyde with £19.7bn in assets and 210,000 members; Orkney Islands is the smallest, with assets of £335m and 3,663 members.[2]

Research by the Scheme Advisory Board, a statutory organisation set up to advise SLGPS and the Scottish Government, shows that the scheme faces a number of significant challenges and, as a result, the current structure of the scheme with its 11 funds should be reviewed.

A selection of these challenges include: the deficit; investment management costs and their transparency; investment performance; volatile investment markets; low interest rates; a maturing scheme membership; and the consequences of implementing investment preferences in respect of certain assets, such as fossil fuels and infrastructure.

Based on this research, the Scheme Advisory Board has identified four options that compare the advantages and disadvantages of retaining the current structure of the scheme without change or, by degrees, consolidating the scheme's 11 constituent funds:

1. Retain the current structure with 11 funds.

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

3. Pool investments between the 11 funds.

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

The purpose of this consultation – requested by the Scottish Government Cabinet Secretary for Finance and Constitution, Derek Mackay MSP – is to ask employers and employee representative groups for their views on each of these options.

Responses gathered in this consultation will be evaluated by the Scheme Advisory Board and presented to Scottish Government Ministers in 2019 to inform any future course of action. As well as this consultation, Ministers will also take into consideration a governance review of public sector pensions being undertaken by the Scottish Public Service Pensions Agency.

This consultation report contains detailed background on how the options were developed including web links to the original research reports; presents arguments for each option; and provides questions that LGPS employers and employee representative bodies should answer to present their views.

The consultation is being managed by Pensions Institute, an academic research organisation hosted by the University of London, on behalf of the Scheme Advisory Board.

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

2 All figures dated 31 March 2017.

How to participate

This consultation is open to LGPS employers and employee representative groups only. To have their views heard, these organisations should respond to the questions in the form accompanying this report and return it via email to the Pensions Institute at consultation@pensions-institute.org no later than Friday, 7 December 2018.

As it is not practical to engage with scheme members directly, respondents who are employee representative bodies are encouraged to canvass the views of their members in order to present their views to this consultation.

Employers who are also administering authorities are additionally invited to give their views from their perspective as authorities. The consultation will attempt to contact all employer members of the SLGPS but the 11 administering authorities should also encourage their admitted bodies to take part in the consultation.

This consultation is being conducted in electronic form only, so responses must be emailed; hard copy posted or delivered responses cannot be received. Any queries about the consultation should be addressed to Matthew Roy, Fellow, Pensions Institute at matthew.roy@pensions-institute.org.

Background to the consultation

1. A review of the structure of the SLGPS was agreed with stakeholders and the Scottish Government Ministers when the changes to the scheme and the new Scheme Advisory Board were introduced in 2015. The Scheme Advisory Board (SAB) proposed carrying out this review beginning in 2016.

2. SAB's proposal was approved by the Scottish Government Cabinet Secretary for Finance and Constitution.

3. Several studies were used to inform this review and make up the background to this consultation. These are summarised in Appendix 1.

4. In February 2017, SAB produced its own review report. This report is informed by the findings of research in Appendix 1 as well as a working party set up by the board comprising employers, trades unions and fund advisers. It also includes two new pieces of research commissioned by SAB from Mercer in 2016 and Iain Clacher at Leeds University Business School in 2017 and these are included as annexes to SAB's review report.

The report can be found at SAB's website lgpsab.scot/consultation2018.

5. In summary, the report sets out four options for the future structure of the local government pension scheme in Scotland:

1) Retain the current structure with 11 funds

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

3) Pool investments between the 11 funds

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

6. The four options were presented to Scottish Government Ministers in May 2017. In January 2018, SAB received a letter from Derek Mackay MSP, Cabinet Secretary for Finance and the Constitution seeking a consultation with SLGPS employers and employee membership bodies on the four options.

7. The next section presents a summary of the arguments detailed in SAB's review report.

Summary arguments for and against the four options

8. The Scheme Advisory Board's 2017 report sets out four main options for the local government pension scheme and this consultation focuses on four criteria in relation to each option:

— Cost of investing: This is the biggest outlay by each fund in SLGPS and research suggest even small reductions in investing costs and, in particular, investment manager fees could have a significant impact on fund performance.

— Governance: Numerous studies show that improving governance produces significantly better outcomes over the long-term and that most pension funds in both the private and public sectors have room to improve in this area.

— Operating risks: Are believed to vary significantly among public and private sector pension funds depending on the effectiveness of the governance processes of each fund and the quality of the executive resources available to individual funds.

— Infrastructure investment: There is an increasing political desire that SLGPS funds be able to invest pension assets in infrastructure should they decide it to be in the interest of members and employers.

9. Below are summarised the advantages and disadvantages of each option in relation to these criteria and the questions asked in the consultation. The full arguments across a wider range of criteria can be found in SAB's review report. Detailed summaries of the arguments for each option are also presented in Appendix 2 of this report.

Option 1: Retain the current structure with 11 funds

10. The first option for the SLGPS is to do nothing and to maintain the status quo by retaining the current structure with 11 funds.

Cost of investing

11. Evaluating the costs of investing in the 11 funds is currently hindered by the funds' different approaches to reporting and a lack of transparency in investment fees. But from an investment perspective, maintaining the current structure is likely to mean that inefficiencies will remain across the SLGPS as most of the funds will not achieve the benefits of scale that have been documented across a number of countries including the UK. These benefits include improved bargaining power and reduced duplication of efforts in administration, governance, spending on advisors and fund management.

12. The consequence of this is that the scheme will continue to cost more per member for some employers than others. Over the long-run, such cost inefficiencies could be considerable and hence require higher contribution rates putting further pressure on local government and employer budgets.

Governance

13. The current structure of the SLGPS is complex and funds have responded by adopting a variety of different processes for managing investment mandates, investment fund performance and investment costs. As a whole, larger funds have greater resources and capacity to establish and manage these processes than smaller funds.

14. However, a potential advantage in maintaining the current structure would be to retain local oversight and strategy. This local connection may be more difficult to retain if centralised asset pools or merged funds were to be created, as are explored in the options below.

Operating risks

15. There is significant variation in the resources funds have to manage governance processes under the current structure. Smaller funds tend to have less executive support than larger funds. Funds run by only a few individuals may face 'key-person' risk where the incapacity or absence of a single individual hampers the operation of the fund.

Infrastructure

16. Funds have different capacities to invest in infrastructure under the current structure. Larger funds are better able to make investments in infrastructure projects, while small funds acting on their own may not have the resources or expertise to invest in these assets.

Question 1:

Please use the attached form when answering these questions and explain your responses.

a) Cost of investing:

- How well informed do you feel about the investment costs in your fund? What information do you rely on to specify and measure these?

- How well does the current system manage investment costs?

- How would you improve the measurement and management of investment costs in the current system?

b) Governance:

- How well informed do you feel about the governance of your fund? What information do you rely on to measure this?

- How well is the current system governed?

- How would you improve governance of the current system?

- How important is it to maintain a local connection with respect to oversight and strategy?

- How would you determine if the benefits of a local connection in governance outweigh the benefits of scale?

c) Operating risks:

- How well informed do feel about the operating risks of your fund? What information do you rely on to specify and measure these?

- How well are operating risks managed in the current system?

- How would you improve the measurement and management of operating risks in the current system?

d) Infrastructure:

- How well informed do you feel about your fund's investments in infrastructure? What information do you rely on?

- How do you rate the current system's ability to invest in infrastructure?

- How would you increase investment in infrastructure in the current system?

e) Do you have any additional comments about this option?

Option 2: Promote cooperation in investing and administration between the 11 funds

17. The second option for the SLGPS is to retain the current structure with 11 funds but promote cooperation in investing and administration between different funds. Cooperation encompasses co-investment, and shared services, where funds agree to share functions in order to achieve cost savings through economies of scale.

Cost of investing

18. Cooperation between funds when hiring investing managers could lead to efficiency gains. One example of this is the investment collaboration between the Lothian and Falkirk funds. This agreement allowed Falkirk to leverage expertise and scale by jointly investing with the larger Lothian fund.

19. The Lothian-Falkirk example suggests that groups of funds could collaborate to lower costs by clubbing together when appointing managers to invest in particular asset classes. In this model, funds would invest in UK equities or other asset classes as one large block rather than as separate mandates across a number of funds.

20. But coordinating such joint procurement decisions in an informal environment may be challenging. Since any party is free to leave the arrangement, any cost savings may not be long lasting.

Governance

21. Under the cooperation option, the current structure of governance would continue. Investment mandates would be directed by the Pension Committee of each fund and each fund would retain local oversight and strategy. As such, cooperation between the funds would be limited in scope by the rules for investing followed by each Pension Committee.

22. Each collaboration arrangement would then require a new subordinate governance process. In the example of Lothian and Falkirk, the Pension Committees of each fund must agree to coordinate when they delegate investment mandates.

23. Although cooperation would require some sharing of control, and more complex governance, it would still retain some local oversight and strategy.

Operating risks

24. Promoting cooperation arrangements would not resolve issues that smaller funds may have with executive support. They would add new layers of complexity which must be managed. The need for funds to coordinate activities has the potential to reduce the effectiveness and responsiveness of the individual investment decisions of each fund, particularly if this slows down the investing process.

Infrastructure

25. In the Lothian-Falkirk example, both funds have been able to jointly invest substantial in infrastructure projects. But it is unclear how well collaboration agreements would scale to include more joint fund investors. Several funds may wish to club together to invest in large scale projects as each fund individually is likely to have only a small allocation available to infrastructure as an asset class. It is unclear if funds could bear the transaction costs and resources this ‘clubbing together’ process would require or if it could be concluded swiftly enough.

<u>Question 2:</u>

Please use the attached form when answering these questions and explain your responses.

a) Cost of investing:

- What impact do you think promoting agreements between funds would have on investment costs?
- What would be the positive impacts?
- What would be the negative impacts?

b) Governance:

- What impact do you think promoting agreements between funds would have on governance?
- What would be the positive impacts?
- What would be the negative impacts?

c) Operating risks:

- What impact do you think promoting agreements between funds would have on operating risks?
- What would be the positive impacts?
- What would be the negative impacts?

d) Infrastructure:

- What impact do you think promoting agreements between funds would have on funds' ability to invest in infrastructure?
- What would be the positive impacts?
- What would be the negative impacts?

e) Do you have any additional comments about this option?

Option 3: Pool investments between the 11 funds

26. The third option covers asset pooling where the assets of distinct pension schemes are consolidated into one or more asset pools to be managed centrally on behalf of the different schemes. Schemes retain their governance, administration and back office functions and continue to appoint and manage many of their advisers. This process would be analogous to the pooling of LGPS assets that is ongoing in England and Wales.

27. Asset pooling would be a significant shift to the way in which the SLGPS manages its investments. From an investment perspective, if there were to be a single aggregated pool, it would have circa £42bn of assets under management more than double the size of the largest fund currently, Strathclyde at £19.7bn in assets.

28. Although funds would be pooled, assets and liabilities would still be allocated by the employer in the same way as the current arrangements. This ensures that employers would still be liable for the pension obligations that they have accrued, for any deficit that they are liable for currently, and for any new benefits that are promised.

Cost of investing

29. Asset pooling has the potential to generate significant cost savings from scale over the long-term. For instance, the larger scale of asset pools could enable the majority of the investment activities of funds participating in each pool to be brought in house, which is likely to create significant cost

efficiencies over time as well as allowing for a more sophisticated and dynamic investment strategy.

30. A significant challenge in successfully pooling assets is achieving scale to cover set- up costs, ongoing operating expenses and governance costs. In the short-term, pooling would generate large initial transitional and set up costs, potentially including the requirement to seek FCA authorisation for the new asset pools.

Governance

31. From a governance perspective, under asset pooling each fund's Pensions Committee would likely retain responsibility for determining the asset allocation for their investments, making funding decisions and ensuring funds were managed in accordance with applicable laws and regulations. However, the day-to-day management of the investments would be delegated to the pool.

32. Each fund would also retain its Pension Board as stipulated in The Public Service Pensions Act 2013, with its existing employer and employee representation, as well as its role to provide advice on the administration and management of the pool.

Operating risks

33. Pooling assets would significantly boost the executive resources available to manage governance process related to day-to-day investing. But investment management risks would become concentrated in the new asset pools. It would be critical to establish clear lines of responsibility to ensure there is accountability for decisions made when managing the pool and to retain local oversight and strategy.

Infrastructure

34. By grouping investments together under single mandates, pooling is expected to significantly boost the capability of the SLGPS to invest in infrastructure. Combined in pools, the buying power of each individual fund's allocation to infrastructure could be exercised collectively, in a coordinated way.

<u>Question 3</u>

Please use the attached form when answering these questions and explain your responses.

a) Cost of investing:

- What impact do you think pooling investments between funds would have on the cost of investing?
- What would be the positive impacts?
- What would be the negative impacts?
- If asset pooling were possible, under what circumstances should a fund consider joining an asset pool?
- Under which circumstances should the SLGPS consider directing funds to pool?

b) Governance:

- What impact do you think pooling investments between funds would have on governance?
- What would be the positive impacts?
- What would be the negative impacts?

c) Operating risks:

- What impact do you think pooling investments between funds would have on operating risks?

- What would be the positive impacts?
- What would be the negative impacts?

d) Infrastructure:

- What impact do you think pooling investments between funds would have on funds' ability to invest in infrastructure?
- What would be the positive impacts?
- What would be the negative impacts?

e) Do you have any additional comments about this option?

Option 4: Merge the funds into one or more new funds

35. The fourth scenario is for funds in the SLGPS to merge, with assets, liabilities and administrative functions being managed by one or more larger funds.

36. Merging pension funds poses a number of challenges. Although funds merge, their assets and liabilities still have to be allocated by the employer, as employers would remain liable for the pension obligations that they have accrued, for any deficit that they are liable for currently, and for any new benefits that are promised.

Cost of investing

37. Fund mergers have the potential to generate significant cost savings from scale over the long-term in the same way that asset pooling does. For instance, the larger scale of funds could enable the majority of the investment activities of merged funds to be brought in-house, which could create significant cost efficiencies over time as well as allowing for a more sophisticated and dynamic investment strategy.

38. Fund mergers may provide additional improvements to the cost of investing over and above pooling. As well as day-to-day investment management, other back office functions would also be combined to lower costs. Larger scale asset pools may also make available additional investment risk management strategies, such as interest rate hedging.

39. In the short-term, merging would generate large initial transitional and set-up costs.

Governance

40. The full merger of SLGPS funds would likely have the most far-reaching consequences for governance. Governance would likely no longer be a local government function and could be the responsibility of one or more central government bodies. Although there would be local government representation on the Pensions Boards of the merged funds, the treasury function of the local authority is no longer likely to have direct involvement in any pension fund matters.

41. The dual board-committee structure could persist or be replaced by different arrangements such as a lead authority or a joint board.

Risk management

42. Mergers, like the asset pooling option, would significantly boost the executive resources available to manage governance process related to day-to-day investing, but additionally bring more executive support to bear in merged back office and administrative support functions.

43. As in asset pooling, it would be critical to establish clear lines of responsibility to ensure there is accountability for decisions made when managing merged funds.

Infrastructure

44. By grouping investments together under single mandates, mergers, like pooling are expected to significantly boost the capability of the SLGPS to invest in infrastructure. Combined in merged funds, the buying power of each individual fund's allocation to infrastructure could be exercised collectively, in a coordinated way.

Question 4

Please use the attached form when answering these questions and explain your responses.

a) Cost of investing:

- What impact do you think mergers between funds would have on the cost of investing?
- What would be the positive impacts?
- What would be the negative impacts?
- If merging were possible, under what circumstances should a fund consider a merger?
- Under what circumstances should the SLGPS consider directing funds to merge?

b) Governance:

- What impact do you think mergers between funds would have on governance?
- What would be the positive impacts?
- What would be the negative impacts?

c) Operating risks:

- What impact do you think mergers between funds would have on operating risks?
- What would be the positive impacts?
- What would be the negative impacts?

d) Infrastructure:

- What impact do you think mergers between funds would have on funds' ability to invest in infrastructure?
- What would be the positive impacts?
- What would be the negative impacts?

e) Do you have any additional comments about this option?

Question 5

Please use the attached form when answering these questions and explain your responses.

a) Which option does your organisation prefer? Please explain your preference. b) What other

options should be considered for the future structure of the LGPS?

c) What would be the advantages and disadvantages of these other option for funds' investment costs, governance, operating risks and ability to invest in infrastructure?

d) Are there any other comments you would like to make?

Appendix 1: Reports of previous pension scheme reviews

Deloitte report

A copy of the Deloitte report can be found SAB's website lgpsab.scot/consultation2018.

In 2011, Deloitte presented research on the merits of combining the investment and administration functions of the SLGPS. This research was conducted as part of a Pathfinder Project to identify potential cost savings and operational efficiencies in SLGPS by adopting shared services. Participants in the research included the Improvement Service, Scottish Government, Convention of Scottish Local Authorities (COSLA), the 11 funds and the Scottish Public Pensions Agency.

The 2011 report considered a number of models including retaining the current structure and merging into one, two or three larger host funds. While Deloitte identified a number of key risks in the current structure, they concluded that the savings in investment management fees would not be significant enough to justify, in cost terms alone, merging funds. They reached a similar conclusion in relation to an improvement in investment performance. They did recommend less active investment management and pointed to the benefits, particularly for small and medium sized schemes, of shared technical advice.

In relation to administrative costs, the report found that costs per member in Scotland compared favourably with funds in England and Wales. However, based on the experience of shared services between Cumbria and Lancashire, Deloitte recommended further consideration of a single operating model and a common administration system – rather than formal administrative mergers.

APG report

A copy of the APG review can be found at SAB's website lgpsab.scot/consultation2018.

In light of increasing awareness about investment fees and performance, UNISON commissioned the Dutch pension group, APG, to undertake a similar review of LGPS pension funds across the UK, including Scotland. APG evaluated data on 101 funds over 2001–09 and modelled the impact of fund mergers.

APG concluded that investment expenses and administration costs decline when the size of fund increases and that larger funds consistently achieved higher investment returns. They also drew upon international studies that show substantial positive economies of scale in asset management.

APG's simulation for one fund in Scotland indicated average annual savings in investment management costs of £7m. They also concluded that improved investment performance could have led to £772m of additional assets for Scottish funds.

Audit Scotland report

A copy of the Audit Scotland report can be found at SAB's website:
lgpsab.scot/consultation2018
or the Audit Scotland website:
www.audit-scotland.gov.uk/report/the-cost-of-public-sector-pensions-in-scotland

In 2011, Audit Scotland reported on the cost of public sector pensions in Scotland. The focus of this review was on the costs of benefits and associated contributions. Audit Scotland summarised the advantages and disadvantages, which essentially come down to economies of scale and expertise as against transition costs and the impact on local governance.

Cost transparency code and FCA market study

Information about the cost transparency code for the local government pension scheme in England and Wales can be found on the scheme's website: lgpsboard.org/index.php/structure-reform/cost-transparency

Information about the FCA's market study into asset management can be found at the authority's website:
www.fca.org.uk/publications/market-studies/asset-management-market-study%20

In 2015, the Financial Conduct Authority (FCA) launched an asset management market study to understand how asset managers compete to deliver value to both retail and institutional investors. The FCA found weak price competition with evidence of sustained, high profits over a number of years.

The local government pension scheme in England and Wales launched a Code of Transparency to improve investment fee transparency and consistency. The voluntary code sets standards for reporting on fees paid to asset managers and was adopted by SLGPS in 2016.

Appendix 2: Overview of advantages and disadvantages for the four options

Criteria	OPTION 1 Retain the current structure with 11 funds	OPTION 2: Promote cooperation in investing & administration between the 11 funds	OPTION 3: Pool investments between the 11 funds	OPTION 4: Merge the funds into one or more new funds
GOVERNANCE	**PROS** Maintains local decision making and connection with respect to oversight and strategy.	**PROS**	**PROS** There is not, at least at a high level, an issue of localism vs centralisation that emerges from merging/pooling; it is simply a question of investing in the most cost effective way to secure member benefits. Professionalise decision making and governance. Some representation of local authorities on a Pensions Committee, which would set broad asset allocation, risk budgets, and risk-adjusted performance criteria for the investment of the assets. Funds may be more focused on the performance and accountability of an investment pool and it is likely that they would exert a high degree of scrutiny on the performance of the pooled assets. Additional gains from better risk-management functions under the ethos that good governance should drive outcomes and not just wrap round a predetermined solution or structure. More arms-length from administering and reduced conflicts of interest.	**PROS** Reduces number of Pension Boards. A fund as large as a pooled Scottish LGPS would be able to attract and recruit the best people.

Criteria	OPTION 1 Retain the current structure with 11 funds	OPTION 2: Promote cooperation in investing & administration between the 11 funds	OPTION 3: Pool investments between the 11 funds	OPTION 4: Merge the funds into one or more new funds
CONS	Potential conflicts between Fund and Administering Authority e.g. in multi-employer fund, setting contribution rates. Duplication across funds in terms of administrative, governance, advisory, and fund management costs, and lack of scale in most of the Scottish LGPS funds. Large number of stakeholders and decision makers including committees and pension boards. Specialist staff recruitment (especially for investment) can be difficult due to terms and conditions of councils and/or for more rural funds. Lack of internal resource and staff in smaller funds have other duties to perform that can be impacted by broader council developments.	CONS	CONS Increase in consolidation of governance thus reducing local governance. A significant shift towards a more central structure such as asset pooling could remove existing functions such as trustees etc. Such change will take time and cost money, both of these factors have to be accepted and the costs and benefits of the envisaged structure would have to be clear and accepted by a wide range of stakeholders. Moreover, the gains to any long-term strategic shift in the operation of the Scottish LGPS are likely to emerge over a number of years rather than immediately or in the short-term.	CONS Governance would no longer be a local government function and would be the responsibility of a quango. Potential disconnect between the employer and the scheme leading to lower local engagement.

Criteria	OPTION 1 Retain the current structure with 11 funds	OPTION 2: Promote cooperation in investing & administration between the 11 funds	OPTION 3: Pool investments between the 11 funds	OPTION 4: Merge the funds into one or more new funds
INVESTMENT	**PROS** Bespoke investment strategy and implementation for each fund. Potential to collectively negotiate with existing managers to reduce fees.	**PROS** Joint procurement of investment managers or other services could lead to some efficiency gains. Potential to leverage some of the internal expertise and scale within the larger funds. Some cost efficiencies could be gained if broad mandates e.g. UK passive equities were to be invested as one large block rather than as separate mandates across a number of funds	**PROS** Significant cost savings resulting from scale. Ability to move towards greater internal management. Professionalisation of investment – FCA authorisation likely to be required. Resolves MIFID II issues. Enable the in-housing of the majority of the investment activities of the fund, which is likely to create significant cost efficiencies as well as allowing for a more dynamic investment strategy. -Increased employment as a result. Ability to invest in new asset classes/opportunities. A more transparent and uniform governance model with potential to improve returns. Collective proactive stewardship opportunities to capture the 'engagement premium' which could add up to 2 to 4% in the first year to returns. Smaller funds gain access to new investment opportunities.	**PROS** Likely that significant cost savings could be generated if there was to be a significant scaling up of pension fund assets as this increases the bargaining power of the SLGPS. Increased sustainability of SLGPS

Criteria	OPTION 1 Retain the current structure with 11 funds	OPTION 2: Promote cooperation in investing & administration between the 11 funds	OPTION 3: Pool investments between the 11 funds	OPTION 4: Merge the funds into one or more new funds
	CONS Inefficiencies will persist and not allowing benefits of scale thus risking future sustainability. Investment mandates, performance targets, and an understanding of costs and fees are unlikely to be optimal. While likely that improved disclosure via better data collection (now underway) will help improve this situation in the coming years, it does not necessarily shift the dynamic between funds and fund managers, as there is only a small increase in bargaining power. Pension funds, in all likelihood, would remain price takers. Limited options for bespoke employer investment strategies. Smaller funds lack influence unable to take an active role as a shareholder. Smaller schemes face key-person risks. MIFID II, and FCA classification of local authorities, could have major impact on investment options available.	**CONS** Relies on Pension Committees and officers being more coordinated / or compromising. Potentially a slow process. Sustainability risk e.g. if one fund decides to terminate agreement. Potential issues relating to unauthorised investment advice due to lack of FCA authorisation. Opportunity of gains limited by virtue of extant governance structures. Does not resolve MIFID II issues. Potential for smaller funds gaining access to new opportunities.	**CONS** Complexity and costs of establishing FCA authorised pool. Could be time consuming to establish. Lose local connection with funds. E&W models untested as yet so there is no track record to assess benefits.	**CONS**

Criteria	OPTION 1 Retain the current structure with 11 funds	OPTION 2: Promote cooperation in investing & administration between the 11 funds	OPTION 3: Pool investments between the 11 funds	OPTION 4: Merge the funds into one or more new funds
FUNDING	**PROS**	**PROS** Greater consistencies of funding approach, depending on service to be shared. Potential for consistent approach to employer covenant and offering different funding options including offering different investment strategies.	**PROS** Funds retain funding decisions. May provide wider range of options for different investment/funding strategies.	**PROS** Employer liabilities remain identifiable thus avoiding concerns with regard to cross-subsidy or netting of gain/losses at the time of merging funds. May provide wider range of options for different investment/funding strategies. Consistent funding approach within each new fund. (See funding challenges section in Annex 5). This could include the approach to employer covenants and the potential to offer different investment/funding options. Resolves the funding inconsistencies and the issue of risk of cessation faced by employers who are admitted to more than one fund. May be an opportunity to separate the liabilities of certain employers from others and put in place different funding arrangements, potentially reducing the exposure of the other employers in the funds. For example, certain groups of employers could be grouped for funding purposes and bespoke admission agreements/guarantees put in place e.g. third sector/charities or colleges. Improves long term sustainability of the SSLGPS.

Criteria	OPTION 1 Retain the current structure with 11 funds	OPTION 2: Promote cooperation in investing & administration between the 11 funds	OPTION 3: Pool investments between the 11 funds	OPTION 4: Merge the funds into one or more new funds
FUNDING	**CONS** Difficult to see the funding position of the Scottish LGPS as a whole. Employers who are admitted to more than one fund have inconsistent funding approaches and risk of triggering cessations. Duplication/inconsistent approach to employer covenant. Limited options for bespoke employer funding strategies.	**CONS** Limited opportunity for improvement and the cons associated with the status quo option would remain.	**CONS** Funds retain funding decisions and inconsistencies persist.	**CONS** Potential lack of customisation of assumptions for different employers.
PENSION ADMINISTRATION	**PROS** More local/ bespoke service.	**PROS** (As per merging funds, depending on the collaboration).	**PROS**	**PROS** Improved economies of scale. Consistent service for all members and employers. Removes duplication. IT system rationalisation and standardisation.

Criteria	OPTION 1 Retain the current structure with 11 funds	OPTION 2: Promote cooperation in investing & administration between the 11 funds	OPTION 3: Pool investments between the 11 funds	OPTION 4: Merge the funds into one or more new funds
	CONS Costs in some schemes will remain higher than they need to be. Inefficiencies in data submission for employers admitted to more than one fund. Inconsistent service for members, particularly evident where employers are admitted to more than one fund. Duplication of effort. Key-person risks.	**CONS** (As per merging funds, depending on the collaboration).	**CONS** As per status quo.	**CONS** Potential loss of local service / local jobs.
INFRASTRUCTURE (note that Investment comments above generally apply)	**PROS** Local funds retain decision making on the type of infrastructure investment.	**PROS** Potential to leverage expertise within existing funds.	**PROS** Scale facilitates direct and co-investments in large infrastructure projects and at lower cost.	**PROS**
	CONS Smaller funds don't have expertise to implement. Safeguards need to be put in place to prevent governmental or local issues driving investment to projects where there is no financial return to the pension fund.	**CONS** Safeguards need to be put in place to prevent governmental or local issues driving investment to projects where there is no financial return to the pension fund.		