ITEM No …6………..

REPORT TO:	**PENSION SUB-COMMITTEE OF THE POLICY & RESOURCES COMMITTEE & PENSION BOARD – 5 DECEMBER 2016**
REPORT ON:	**REPATRIATION OF TRANSPORT FUND**
REPORT BY:	**EXECUTIVE DIRECTOR OF CORPORATE SERVICES**
REPORT NO:	**402-2016**

1 PURPOSE OF REPORT

This report sets out the proposal to repatriate the assets and liabilities of the single employer, Tayside Transport Fund back to the main fund. It presents specialist opinion on the proposal and requests agreement to proceed.

2 RECOMMENDATION

The Sub-Committee is asked to agree in principle to the proposal of repatriation of the Transport Fund subject to final agreement of employer contribution rate and guarantee as required by Tayside Pension Fund specialist advisors.

3 FINANCIAL IMPLICATIONS

The actuarial calculations support a fixed employer contribution rate of 40%. Whilst this cannot guarantee adequate funding to meet pension liabilities, the risk is not considered significant to have any material impact on employer contribution rates.

In terms of costs to the fund in relation to moving the assets, any costs associated with the repatriation would be met by the savings in administration and operational expenses.

4 BACKGROUND

There has been an ongoing exercise to identify various options to improve efficiencies in respect of the Main and Transport Fund. Available options considered included those that may also benefit the main fund in terms of efficiencies in fund administration and management.

5 PROPOSAL

In March 2016, Tayside Pension Fund discussed a proposal with Xplore Dundee (the respective employer of Tayside Transport Fund) to transfer the assets and liabilities of the Transport Fund back to the main fund both for accounting and operational purpose and to gain certainty over future contributions.

6 SPECIALIST OPINIONS

6.1 Barnett Waddingham (Fund Actuary)

The proposal has since undergone actuarial scrutiny (Appendix 1). Findings show the proposal is expected to provide an ongoing funding surplus which would assist all other employers in the fund in maintaining existing levels of funding. Due to the unknown future investment returns it would require Xplore Dundee to pay a fixed contribution level which would incorporate a “certainty” premium to provide additional comfort that the continuing contributions and asset values would be sufficient to accommodate it’s future pensions liabilities until final cessation. A deficit risk would still remain, but this would not be of a level which would have any impact on the contribution rate of the fund. In summary, if Xplore Dundee were to agree to the 40% actuarially calculated rate, the fund’s actuaries believe the proposition to be attractive.

6.2 Pinsent Mason (Fund Legal Advisor)

The Fund sought specialist legal opinion (Appendix 2) and have been advised that no pensions legislation currently contains a mechanism to facilitate the repatriation. However, if an employer consultation is undertaken, and is met positively (or, at least, neutrally) by the other employers in the Main Fund and that no employer raises a material objection, challenge would be unlikely. They deemed it appropriate and reasonable for the fund to proceed with the repatriation should it be satisfied that it can take the necessary steps outwith specific legislation.

They also raised the consideration of employer providing a guarantee in respect of any exit charge in the event of a default and/or any other event that triggers an exit charge. This would provide additional security and confidence that the repatriation is clearly in the interests of Main Fund (including former Transport Fund) beneficiaries and does not present a risk to the other employers in the Main Fund over the longer term.

6.3 **AON Hewitt (Fund Investment Advisor)**

The fund sought specialist investment opinion on the repatriation proposal as well as the other considerations of alternative investment strategies (Appendix 3) and has gained confirmation that the repatriation of the Transport Fund assets and liabilities provides potential benefits of long term cost reduction and governance savings.

7 EMPLOYER CONSULTATION

Following receipt of specialist opinion, the fund undertook employer consultation (which closed on 31st October) to seek their views prior to Committee submission. The fund had one response (from Angus Council) seeking confirmation that the proposal would have no negative effect on overall employer contribution levels or funding.

8 CONCLUSIONS

The investment managers have demonstrated clear cases for investment in order to achieve their objectives, and whilst not restricting their investments, our policy to detract when circumstances allow still prevails without compromising the fiduciary case.

9 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 none.

10 CONSULTATIONS

The Chief Executive and the Head of Democratic and Legal Services have been consulted in the preparation of this report.

11 BACKGROUND PAPERS

None

MARJORY M STEWART
EXECUTIVE DIRECTOR OF CORPORATE SERVICES **5 DECEMBER 2016**

APPENDIX 1

Barnett Waddingham
a true partnership approach

Client Advice Note

Client	**Tayside Pension Funds**
Subject	**Repatriation of Transport Fund**
Prepared by	**Graeme D Muir FFA**
Date	**25 November 2016**

1. Introduction

1.1 In 1986 bus services were de-regulated and bus staff, previously employed by the local authority (in this case Tayside Regional Council), were transferred to a separate company – Tayside Transport. A separate pension fund – the Tayside Transport Fund - was created by apportioning the Main Fund and the pension liabilities for staff employed by the new bus company were transferred to that Fund. A number of years later the bus company was sold and the current owners are Xplore Dundee, a subsidiary of National Express.

1.2 When the company was sold the Transport Fund was closed to new staff and so eventually the Transport Fund would no longer have any active members. At the last actuarial valuation of the Transport Fund there were only 65 active members left (compares over 500 deferred and current pensioners). It is anticipated that at the next valuation due as at 31 March 2017 the number of active members will have fallen further.

1.3 Given the very mature nature of the Transport Fund, the contribution rates payable by Xplore Dundee are likely to be quite volatile. In addition the Transport Fund will start to reduce in value as liabilities are met – at the 2014 valuation the assets were £56m (compares £2.5bn for the Main Fund).

1.4 It has been proposed therefore that it would be much more efficient to repatriate the Transport Fund back into the Main Fund. However as an open fund the Main Fund has quite a different liability profile and accordingly a different investment strategy which does not really fit with the liability profile of the Transport Fund liabilities and could result in greater volatility in Xplore Dundee's contribution rate. In addition the funding target for the Transport Fund is quite different to the Main Fund in that for the Transport Fund the objective is to be fully funded on a gilts or minimum risk basis. In the Main Fund the funding target is lower reflecting the stronger covenant of the employers in the Main Fund.

1.5 Accordingly it has been further proposed that as an employer in the Main Fund, an arrangement could be made to essentially fix Xplore Dundee's contribution rate at a constant percentage of pay until there are no longer any active members at which point Xplore Dundee would cease to be an employer in the Fund.

1.6 Such an arrangement would also mean that Xplore Dundee could essentially account for its pension costs on a "defined contribution" basis. This would mean no balance sheet pension liability and a stable (and generally reducing) pension cost in their P&L.

1.7 Dundee City Council, as administering authority, has sought legal advice in this respect. The advice is that the repatriation is possible provided it can be essentially demonstrated that it is not to the detriment of the employers in the Main Fund.

The key issue therefore is to ensure that the likelihood that the assets of the Transport Fund and the fixed level of contributions payable by Xplore Dundee until all active members have retired will be enough to meet the remaining pension liabilities currently in the Transport Fund is sufficiently high so that the other employers in the Main Fund are unlikely to have to meet any future deficits in respect of these liabilities.

2. Purpose of this report

2.1 The purpose of this report is therefore to provide an actuarial opinion on the likelihood of the assets and future contributions being sufficient and to assess the proposed fixed level of contribution that will be payable by Xplore Dundee. This report is addressed to Dundee City Council as administering authority to Tayside Pension Fund. This report may be shared with other interested parties but does not constitute advice to them.

2.2 Of course it is impossible to provide any guarantee as the outcome will depend on what will actually happen in future. However, using actuarial models it is possible to assess the probability of the desired objective being met.

2.3 This advice complies with all Generic Technical Actuarial Standards and the Pensions TAS issued by the Financial Reporting Council.

3. Data

3.1 The main data used in the calculations are:

- the results of the actuarial valuation of the Transport Fund as at 31 March 2014
- the funding update of the Transport Fund as at 30 September 2016

3.2 The results of the valuation of the Transport Fund as at 31 March 2014 were:

- Essentially a fully funded position with assets sufficient to meet the accrued liabilities allowing for a volatility reserve of 5% of the assets.
- The required employer contribution rate to meet the further accrual of benefits for active members of 33.8% of pensionable pay.
- At the date the valuation report was signed in February 2015, the ongoing accrual cost of 33.8% had increased to nearer 40% due to essentially a reduction in gilt yields. However as the funding position was still satisfactory and the volatility reserve was still positive, and recognising that the overall position would inevitably fluctuate with market conditions, the contribution certified for Xplore Dundee was set at 33.8% of pensionable pay with effect from 1 April 2015.

3.3 Since then we have continued to monitor the funding position of both Funds in the run up to the next valuation due as at 31 March 2014. The position of the Transport Fund is included in Appendix 1.

3.4 As can be seen the funding level is still very close to 100% although the volatility reserve has been exhausted and the ongoing accrual cost is around 47% of payroll. Note however that the funding updates are only approximate calculations and only reflect changes in market conditions and asset values. They do not reflect any underlying “experience” – pensioner mortality, actual pension increases etc. We suspect that if a full valuation had been carried out as at 30 September 2016, the actual funding level may have been slightly higher.

3.5 It is also important to recognise that in the funding strategy for the Transport Fund, there is no advance recognition of expected investment returns over and above the returns available from gilts. So rather than recognise the expected outperformance now, the funding strategy is to wait for the asset outperformance to emerge (which of course, whilst expected, is not guaranteed).

3.6 For the Main Fund however, due to the open nature of that Fund and the strong covenant of the employers with most of the liabilities, some advance allowance is made for investment returns above gilts. If the asset performance doesn't materialise then employers will have to pay more in future. Given the strong covenant of the employers with most of the liabilities, this is not deemed to be an issue. The level of asset outperformance is still prudent relative to "best estimates".

3.7 Thus, if and when the Transport Fund repatriates with the Main Fund, a small surplus (reflecting the assumed asset outperformance) will emerge, although given the relative sized of both Funds this will not be materially significant for the Main Fund. However, using the Main Fund assumptions (and in particular allowing for the asset outperformance) it does mean that the Main Fund will receive more assets than liabilities and so reduce the likelihood of the Main Fund employers ever having to meet any deficit in respect of those liabilities.

4. Xplore Dundee Contribution Rate.

4.1 The other key issue is what level of employer contribution should be paid by Xplore Dundee under the proposed "fixed contribution" agreement.

4.2 Whilst the current level of contribution has been set at 33.8% of pay until 31 March 2018, the funding updates indicate that, using the same approach as adopted at the 2014 valuation, the ongoing cost has increased to currently around 47% of pay. The recent "spike" in the ongoing costs has primarily been due to the impact of Brexit on the gilt market although gilt yields have started to increase since end September. For most months since the last valuation date, the ongoing cost has been less than 40% of pay.

4.3 Of course under the proposed fixed contribution arrangement, Xplore Dundee will no longer be exposed to any pension risk and will have the certainty of a fixed level of employer contribution. Arguably therefore the required level of contribution should have some element of "certainty premium" and so be higher than the ongoing accrual cost where there is still some risk that it may turn out to not be enough.

4.4 Deciding what that should be is of course subjective. To proceed however, using BWarm, our in-house economic scenario generator, we have simulated 10,000 outcomes until 2032 (the time when the last active member is expected to retire) and assessed the funding position at that point in time assuming a fixed level of employer contribution of 40% of payroll.

4.5 In particular we have counted the number of times that the outcome is a deficit to assess the probability of such an outcome. In making this assessment we have assumed future investment returns in line with the Main Fund Strategy. The expected returns and return variations and correlations from the asset classes are included in Appendix 2.

5. Results

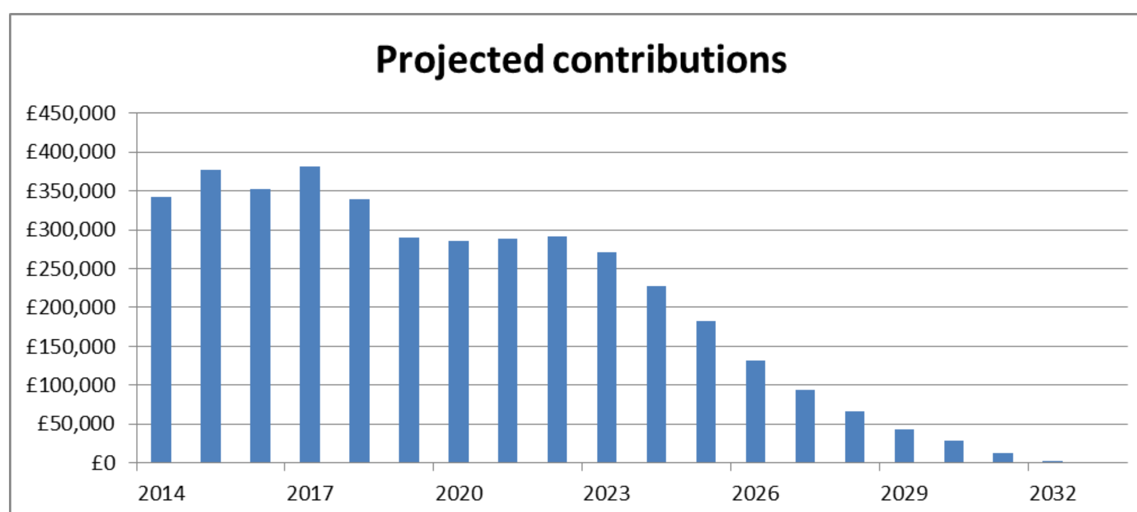
5.1 The analysis allows us to assess the probabilities of various outcomes. The key outcome we have measured is the funding position in 2032 and in particular whether the assets will be sufficient to meet the liabilities – i.e. – there is a surplus. We have also assessed the probability that the surplus will be at certain levels. We have expressed the surplus in real terms or in "today's money" – i.e. allowing for inflation in the period from now until 2032.

5.2 The results of the analysis are

- There is an 88% chance of there being a surplus and so a 12% chance there could be a deficit.
- The probability of the deficit exceeding £5m is 10% and there is a 5% chance it could exceed £13m.
- The most likely outcome is a surplus however and the expected surplus is £50m.
- However there is a significant probability of the surplus being different to £50m. There is a 50% chance it could be in the range £15m to £110m. Thus there is a 25% chance it could be less than £15m and also a 25% chance it could be more than £110m.

5.3 The underlying investment returns from the model are set out in Appendix 2. Note these are "best estimates" and are higher than would be used for valuation purposes as in valuations we build in margins for prudence. So for example if returns were assumed to be 1% lower than this then the 12% deficit chance increases to 16%, the expected surplus reduces to £42m and the 50% range reduces to £10m to £90m.

5.4 We also considered re-running the model assuming a different fixed level of contribution. However given the very mature nature of the Transport Fund the results are not particularly sensitive to this parameter. The projected contributions from 2014 assuming 40% comes into force on 1 April 2017 is as follows:



5.5. The average level of contribution is just over £200k per annum which is around 0.3% of the current asset value so paying anything different to 40% is not going to influence the outcome in any material way.

6. Conclusions

6.1 The results of the analysis suggest that assuming a 40% of pay fixed contribution from Xplore Dundee until all active members are expected to have left will result in an expected surplus of around £50m at that point in time in today's terms.

6.2 There is a probability of 50% that the surplus could be in the range £15m to £110m.

6.3 There is no guarantee there will be a surplus but the probability of there being a deficit is 12% and there is a 5% chance it could be at least £13m. £13m is less than 0.5% of the current value of the Main Fund and in 2032 would be a much smaller percentage and so have no material impact on the Main Fund employers' contribution rates. The impact would be less than 0.01% of pensionable pay. An expected surplus of £50m would reduce employers contributions by just under 0.1% of payroll

6.4 The proposed fixed level of contribution to be paid by Xplore Dundee does not have a material impact on the outcome – we would therefore suggest that the level is set relative to the assessed level of ongoing accrual cost plus a "contribution certainty premium".

6.5. On a minimum risk basis the ongoing accrual cost was assessed as 33.8% of payroll at the 2014 valuation. This assumed that future contributions would be invested in gilts assuming an average gilt yield of 3.6% over the period to 2032. Since the valuation date yields have fallen and this has reduced the prospective return from investing in new gilts. However gilt prices and yields have been particularly volatile in the very recent past due to Brexit and other political concerns. However they are now on the increase and the expectation would be that they revert to closer to 2014 levels and possibly beyond.

6.6. So taking account of longer term expectations of gilt yields and allowing for a continuation of some reversion to more historical levels suggests that a level of contribution under the proposed fixed contribution proposal of 40% of payroll has a sufficiently prudent level of certainty premium.

6.7. Accordingly it is my opinion that fixing the level of contribution at 40% of payroll includes a sufficiently robust level of certainty premium.

6.8. We would be pleased to answer any questions arising from this report.

Graeme D Muir FFA

APPENDIX 1 TRANSPORT FUND FUNDING UPDATES

Valuation date	Smoothed assets £000s	Volatility reserve £000s	Assets for valuation £000s	Liabilities £000s	Surplus/ Deficit £000s	Funding level %	CARE ongoing cost (% of payroll)	Discount rate
31 Mar 2014	56,805	2,628	54,177	54,251	(74)	99.9%	33.8%	3.6%
30 Apr 2014	56,829	2,379	54,451	54,525	(74)	99.9%	34.1%	3.6%
31 May 2014	56,930	2,047	54,883	54,958	(75)	99.9%	34.5%	3.5%
30 Jun 2014	57,074	1,809	55,265	55,341	(75)	99.9%	34.8%	3.4%
31 Jul 2014	57,195	1,368	55,827	55,903	(76)	99.9%	35.4%	3.3%
31 Aug 2014	57,357	978	56,379	56,456	(77)	99.9%	35.9%	3.2%
30 Sep 2014	57,616	345	57,271	57,349	(78)	99.9%	36.8%	3.1%
31 Oct 2014	58,352	0	58,352	58,564	(211)	99.6%	38.0%	2.9%
30 Nov 2014	58,714	0	58,714	59,142	(429)	99.3%	38.6%	2.8%
31 Dec 2014	59,720	0	59,720	59,994	(274)	99.5%	39.5%	2.6%
31 Jan 2015	60,956	316	60,640	60,723	(83)	99.9%	40.2%	2.5%
28 Feb 2015	61,624	767	60,857	60,940	(83)	99.9%	40.6%	2.5%
31 Mar 2015	62,146	1,416	60,730	60,813	(83)	99.9%	40.5%	2.5%
30 Apr 2015	62,061	2,513	59,548	59,629	(81)	99.9%	39.4%	2.6%
31 May 2015	61,890	2,234	59,657	59,738	(81)	99.9%	39.5%	2.6%
30 Jun 2015	61,423	1,689	59,734	59,816	(82)	99.9%	39.7%	2.6%
31 Jul 2015	60,645	1,147	59,498	59,579	(81)	99.9%	39.5%	2.7%
31 Aug 2015	60,043	658	59,385	59,466	(81)	99.9%	39.4%	2.7%
30 Sep 2015	59,486	42	59,444	59,525	(81)	99.9%	39.5%	2.7%
31 Oct 2015	59,616	128	59,488	59,569	(81)	99.9%	39.6%	2.6%
30 Nov 2015	59,708	240	59,468	59,550	(81)	99.9%	39.6%	2.6%
31 Dec 2015	60,292	758	59,533	59,615	(81)	99.9%	39.7%	2.6%
31 Jan 2016	60,168	587	59,581	59,663	(81)	99.9%	39.8%	2.5%
29 Feb 2016	60,122	234	59,888	59,970	(82)	99.9%	39.9%	2.5%
31 Mar 2016	60,262	0	60,262	60,345	(83)	99.9%	40.3%	2.4%
30 Apr 2016	60,884	0	60,884	61,194	(310)	99.5%	41.2%	2.2%
31 May 2016	61,939	0	61,939	62,339	(400)	99.4%	42.4%	2.0%
30 Jun 2016	62,659	0	62,659	63,617	(958)	98.5%	43.7%	1.9%
31 Jul 2016	64,077	0	64,077	65,053	(976)	98.5%	45.2%	1.8%
31 Aug 2016	65,252	0	65,252	66,081	(829)	98.7%	46.2%	1.7%
30 Sep 2016	66,595	0	66,595	67,286	(692)	99.0%	47.5%	1.6%
31 Oct 2016								
30 Nov 2016								
31 Dec 2016								
31 Jan 2017								
28 Feb 2017								
31 Mar 2017								

APPENDIX 2 BWARM ASSET RETURN ASSUMPTIONS

A.2.1 The following tables set out the return assumptions used in the BWarm modelling:

A2.2 The assumptions adopted are set out below. These assumptions are based on a combination of historical analysis, econometric estimation, macro-economic model simulation and judgement both by Barnett Waddingham and external sources. The assumptions are intended to represent "best estimates" and are based on passive implementation with no allowance for potential additional risk or return as a result of active management (except for the target return asset class which is inherently actively managed).

A2.3 The output from the model is sensitive to the choice of assumptions and should therefore always be considered in the context of the assumptions that have been adopted. The one year standard deviation figures relate to the distributions of returns looking over each of the next 30 years in aggregate. The ten year figures relate to the next ten years.

A2.4 In modelling future outcomes we have used the Main Fund strategy asset out in the Statement of Investment Principles which is broadly 70% equities, 18% bonds and 12% property. We have assumed that this strategy will stay in place over the projection period.

A2.5 We have also set out the correlation assumptions between asset classes used in the projections. Correlations are not constant over time. The degree of co-movement between various asset classes will change over time and this effect is allowed for within the projections. As such the table shows the arithmetic mean correlations between the various asset classes.

Asset/index	1 year median return p.a.	10 year median return p.a.	30 year median return p.a.	One year standard deviation
UK equities	9.40%	6.60%	6.90%	16.30%
Property	7.30%	5.60%	6.30%	9.00%
Target return	8.20%	6.60%	7.30%	7.90%
Over 15 year UK index-linked gilts	3.50%	2.70%	3.50%	15.60%
Over 15 year UK corporate bonds	4.60%	3.80%	4.60%	9.30%
RPI inflation	3.50%	3.00%	3.50%	1.90%

Correlations	UK equities	Property	Target return	Over 15 year index-linked gilts	Over 15 year UK corporate bonds	RPI inflation
UK equities	**100%**	54%	54%	-13%	6%	11%
Property	54%	**100%**	46%	-7%	5%	10%
Target return	54%	46%	**100%**	-8%	8%	10%
Over 15 year UK index-linked gilts	-13%	-7%	-8%	**100%**	98%	6%
Over 15 year UK corporate bonds	6%	5%	8%	98%	**100%**	5%
RPI inflation	11%	10%	10%	6%	5%	**100%**

Limitations of asset-liability modelling

A2.6 Asset-liability models such as this are not intended to be predictive of the future. Unexpected events can and do happen in global markets and such uncertainty is impossible to accurately model and the output of any model is only as good as the parameters that the model uses. The future is, or course, unknown, and if the world economy turns out to be different from that implied by the assumptions then the level of risk could turn out to be higher or lower than predicted by the model.

A2.7 The scenarios of most interest are also the ones which are most difficult to model. These are the scenarios which incorporate large changes in asset values or yields. The difficulty in modelling such extreme events is that they occur infrequently over time; it is not possible to say for certain what level of loss is likely to occur one year in 100 as we have only one period of this length to inform our estimate of this risk. The level of risk based upon historic analysis is therefore likely to be lower than the true value.

A2.8. It is important to bear in mind that a model which overestimates the level of risk can cause as many problems as one which underestimates risk as it can lead to too much caution and, in this case, could lead to excessive contributions being paid.

APPENDIX 3 OTHER ASSUMPTIONS

A3.1 Demographic assumptions are consistent with those used for the 2014 valuation.

A3.2 As at the previous valuation; the discount rate used to value pension liabilities is the gilt yield at the date of valuation. The rates used in each scenario are generated using the BWarm model with parameters set out in Appendix 2.

A3.3 The discount rates assumed in the model differ from the assumed return as the Fund is assumed to be invested in a range assets including higher return seeking assets.

APPENDIX 2

Dundee City Council (the "Council")

Legal advice to the Council in relation to proposed transfer of the Tayside Pension Fund and the Tayside Transport Fund

Background

We have now had an opportunity to consider whether the Council, as administering authority for the Tayside Pension Fund (the '**Main Fund'**) has the power to accept a transfer in of assets and liabilities from the Tayside Transport Fund (the '**Transport Fund'**) in respect of active, deferred and pensioner members, thereby effectively repatriating the Transport Fund into the Main Fund (the "**Repatriation**")

There are four options we have been exploring and we have set these out below.

Option 1: Powers under the admission agreement

Gowlings' note suggests an approach which relies on provisions contained in the original minute of agreement between Tayside Regional Council and Tayside Public Transport Company Limited (the '**Admission Agreement**'). The Admission Agreement states that the agreement may be terminated by either party (with 28 days' notice), and it also says that:

'*If the termination of the Agreement is at the request of the Employing Body and the Employing Body wishes to transfer its assets in respect of certain of its pensionable employees to another approved Scheme such transfer shall be in accordance with Regulation Q2*.'

Gowlings argue that the reference to 'another approved Scheme' should be interpreted as including the Main Fund, and they consider that the provisions of Regulation Q2 have been brought forward into the current legislation, albeit in a slightly different form.

However, in our view it is a stretch to say that this was intended to cover transfers into the Main Fund (as opposed to an unrelated approved scheme). In any case, while this provision may provide a mechanism (through Regulation Q2 and its current equivalent) whereby a transfer amount should be calculated, it cannot confer an obligation on another scheme (whether that be an unrelated scheme, or an LGPS fund) to accept such a transfer. The Local Government Pension Scheme (Scotland) Regulations 2014 (the '**LGPS Regulations'**) do not include a power whereby a bulk transfer-in can be accepted, and we do not consider that such a power can easily be inferred from this agreement. This is particularly the case since, at the time the Admission Agreement was entered into, there was a clear mechanism under legislation whereby the 'further fund' could be dissolved and transferred back into the Main Fund, as explained below.

Therefore, proceeding with this route leaves open the possibility of a challenge. The most likely avenue for a challenge would be from employers in the Main Fund who could raise concerns that, if the Transport Fund was less well funded than the Main Fund, the Repatriation would reduce the overall funding level in the Main Fund and potentially increase the contribution rate payable by all employers.

We understand that the preliminary actuarial advice provided to the Fund on this point indicates that:

(i) it is more likely than not that the funding impact of the Repatriation would benefit all employers in the Main Fund; and

(ii) in any event, the impact of the Repatriation on the funding of the Main Fund is not material.

This suggests that the risk of challenge is likely to be technical only as no employer in the Main Fund would be disadvantaged (or be able to prove a loss) as a result of the Repatriation.

We also understand that the Council is proposing to consult with all other employers in the Main Fund about the Repatriation and the likely impact of the Repatriation on the Main Fund prior to taking a final decision on the Repatriation (the "**Consultation**").

On the assumption that the Consultation is met positively (or, at least, neutrally) by the other employers in the Main Fund such that no employer raises a material objection, the risk of challenge is unlikely to come to fruition. Therefore, in terms of risk analysis, it would be appropriate and reasonable for the Council to proceed with the Repatriation on the basis of Option 1 should it be satisfied that it can take the necessary steps without a specific power. To assist the Council we can work with Gowlings to draft a suitable agreement to enable the Repatriation on the basis set out in Option 1.

Option 2: Power to dissolve 'further funds'

The Admission Agreement set up the Transport Fund as being a 'further fund', within the meaning of the Local Government Superannuation (Funds) (Scotland) Regulations 1986 (the '**Funds Regulations'**). This legislation provided that 'further funds' could be set up in relation to the main superannuation fund (in this case, the Main Fund).

Regulation 8 of the Funds Regulations contained a provision whereby an administering authority may dissolve a further fund, and transfer its assets back into the main fund (as long as 28 days' notice is given to the relevant employer(s)). (And any entitlement for members to participate in the Further Fund would become an entitlement to participate in the Main Fund going forward.)

This provision would have, helpfully, given the Council the necessary power to dissolve the Transport Fund and transfer the assets into LGPS. However, it has dropped out of the legislation - it ceased to be in force from December 1987.

The LGPS Regulations refer to 'admission agreement funds', which appear to be broadly the same thing as 'further funds', but there is nothing in either the main LGPS regulations, or transitional regulations (covering the changes in legislation), as to how pre-existing 'further funds' should be dealt with. Even if we could be confident that 'further funds' were brought forward into the new legislation as 'admission agreement funds', there are no provisions as regards the termination of Admission Agreement Funds, other than the general provision regarding exit payments, which apply whenever an employer ceases to be a Scheme Employer. There is no equivalent to Regulation 8 of the Fund Regulations.

Because of this, we do not think there is any clear power within the legislation whereby the Council can terminate the Transport Fund and transfer the assets into LGPS, One approach might be to argue that Regulation 8 fell away from the legislation without any clear intent by the legislators, and that it makes no sense for there now to be no mechanism to terminate the 'further funds' that were set up under the old legislation. The parties could infer, from the gap in the legislation, that where a further fund now needs to be terminated, then the appropriate mechanism is the one that was formerly set out in the legislation, even though those provisions have not been replaced in the current legislative framework.

It is difficult to see how it would be to anyone's detriment if this approach were taken, since Members' benefits will be fully protected when they are transferred across. However, the possibility of challenge cannot be ruled out.

Again, the most likely avenue for a challenge would be from employers in the Main Fund (and the same discussion on risks and materiality as described above applies).

Option 3: New powers under the LGPS Regulations

The LGPS Regulations do not contain any mechanism whereby a bulk transfer-in or repatriation of a scheme without consent into the LGPS (from any source) can be effected (the LGPS Regulations anticipate transfers via an individual member request but not on an inward bulk basis).

We are aware of one case in England where there was a bulk transfer into LGPS from another public sector scheme, but this required explicit legislation to be enacted.

Clearly, specific legislation could be sought (perhaps in concert with other LGPS funds facing similar issues) to enable the Repatriation to go ahead without any concerns over the legislative position. However, such an approach would be time consuming and costly and would delay the Repatriation indefinitely.

Option 4: General powers available to the Council

Local authorities in Scotland have a general power to do things of their choice for the good of their local communities. Section 20 of the Local Government (Scotland) Act 2003 ("**the 2003 Act**") confers a power on local authorities to do anything which it considers is likely to promote or improve the well-being of its area.

Scottish Government guidance provides that the breadth of the power is such that local authorities should regard it as a "*power of first resort*" when they are in any doubt about whether existing powers would enable them to take a particular course of action or deliver a particular service. That is, rather than searching for a specific power elsewhere in statute in order to take a particular action, the Scottish Government in fact encourages local authorities to look to the new power in the first instance in taking forward measures likely to promote and improve well-being. This means that the power is generally viewed quite generously. Specific examples of the kind of action that can be taken are set out in section 20(2) of the Act which states that the power to advance well-being includes the power to:

1. Enter into arrangements or agreements with any person;
2. Co-operate with, or facilitate or co-ordinate the activities of, any person;
3. Exercise on behalf of any person any functions of that person, and
4. Provide staff, goods, materials, facilities, services or property to any person.

In deciding whether section 20 of the 2003 Act can be relied upon in the present the case, consideration will need to be given as to whether accepting the transfer of assets and liabilities from the Transport Fund to the Main Fund is likely to promote or improve the well-being of their area and/or persons in it – clearly there will be a cost saving to the Council (and so the taxpayer) in effecting the Repatriation and this may well form the basis of the use of Section 20 should the Council be minded to use this route.

In addition, we would normally expect the power to be used in the pursuit of local authority functions and objectives. That is to say, the power cannot normally be relied upon to deliver a measure which a local authority would not ordinarily be tasked with providing. Providing pension benefits in an efficient way (via the Repatriation) would, on the face of it, appear to be a standard function and objective of the Council.

The Council will need to be comfortable that it has a robust argument that the transfer sits within its functions and will improve the well-being of its area and/or the persons within it. In the absence of a clear precedent in this regard, we would recommend that Counsel's opinion be obtained to ensure that the Council, in accepting the transfer, is not seen to be acting ultra vires. We would anticipate that Counsel's opinion could be sought fairly quickly and for good value on this discrete issue.

Given that the administrative authority rather than the Council itself would be exercising some or all of the powers required to achieve the Repatriation, and the absence of a clear precedent for using Section 20 in a pensions law context, this route may increase the issues and risks relating to the Repatriation.

Conclusions and next steps

It is frustrating that the pensions legislation does not provide a straightforward mechanism to enable the Repatriation to take place (particularly as a mechanism had existed previously).
The proposed approach from Gowlings (Option 1) appears to be the most workable but is based on the Council taking a decision without having a specific power to do so under the pensions legislation. As such Option 1 is subject to challenge and risk.

Given that the preliminary actuarial advice provided to the Fund indicates that the risk of challenge is likely to be technical only and that the Council is proposing to undertake the Consultation, the Council may be willing to proceed on the basis proposed by Gowlings in Option 1. On the assumption that the Consultation is met positively (or, at least, neutrally) by the other employers in the Main Fund such that no employer raises a material objection, the risk of challenge is unlikely to come to fruition. Therefore, in terms of risk analysis, it would be appropriate and reasonable for the Council to proceed with the Repatriation on the basis of Option 1 should it be satisfied that it can take the necessary steps without a specific power.

Some thought should be given as to whether steps could be taken by the private sector owners of the Transport Company to further mitigate the risk by, for example, providing a guarantee in respect of any exit charge due from the Transport Company to the Main Fund (following the Repatriation) in the event of a default by the Transport Company and/or any other event that triggers an exit charge. By securing additional security in this way the Council can be more confident that the Repatriation is clearly in the interests of Main Fund (including former Transport Fund) beneficiaries and does not present a risk to the other employers in the Main Fund over the longer term.

Pinsent Masons LLP
Updated: 6 October 2016

APPENDIX 3

Considerations for the Tayside Transport Fund

Prepared for	Dundee City Council
Prepared by	Aon Hewitt
Date	15 November 2016

Introduction

Background

Over the course of 2015 and 2016 Dundee City Council (“the Council”) has been considering various options to improve investment and other efficiencies in respect of the Tayside Transport Fund ("the Transport Fund") including any options to increase efficiencies, reduce ongoing costs and improve the security of benefits to members that might be available through the Tayside Pension Fund ("the Main Fund").

Essentially, in the context of increasing efficiencies and / or reducing ongoing costs, three options can be considered;

- Liability Driven Investment ("LDI")
- A Pensioner Buy-in
- Repatriation of the Transport Fund into the Main Fund

LDI and a Pensioner Buy-in can be considered predominantly as investment strategy decisions whereas a repatriation of the Transport Fund into the Main Fund represents a more significant change and is really the only option that could be expected to deliver meaningful ongoing cost savings alongside investment and other efficiencies.

In this report we consider these three options. In particular, we discuss the key considerations involved in each of the three options. We discuss the special circumstances of the Transport Fund that make potential repatriation of the Transport Fund into the Main Fund a particularly relevant and attractive option.

Liability Driven Investment

What is Liability Driven Investment?

The phrase "Liability Driven Investment" (or LDI) refers to a range of strategies in which a defined benefit pension fund's assets are invested, to a greater or lesser extent, in order to provide a close match to its liabilities, or at least one of the bases on which its liabilities are calculated.

Generally, a defined benefit pension fund's liabilities are valued by discounting future cashflows using a long term expected rate of return. Often these are linked to long-dated interest rates, and within the LGPS in particular there is a strong link to inflation. If inflation expectations increase, for example, then the present value of the liabilities also increase since the pension fund needs to put more money aside now, or achieve a higher rate of investment return, to meet the future pension payments promised to members
.

LDI is an investment strategy, which has the broad aim of trying to limit fluctuations in the funding level arising through economic factors (such as inflation) affecting the value of the assets and liabilities differently. We are deliberately concentrating on inflation rather than interest rates here, because your Fund Actuary has a particular way of establishing the discount rate which focuses more on broader investment market factors than purely considering long-dated interest rates as the starting point.

As such, an LDI investment strategy involves investing (some or all of the assets) in investments whose value moves in a similar way to the value of the liabilities as economic conditions change. The strategy can range from a simple strategy of using bonds (for example index linked Gilts) to broadly match liabilities (in reality, bonds are poor liability matching assets due to the very long maturities of a defined benefit pension fund's liabilities and the relatively short maturities of available bonds) to more complex but potentially more capital efficient strategies using swaps and gilt repos.

How does LDI work?

A defined benefit pension fund can 'hedge' itself against a fall in interest rates and increases in inflation by investing in bonds or swaps since the cashflows from these assets are similar in nature to the liability cashflows, and hence the values of these investments change in similar ways to the changing liability value, given the same stimulus.

Bonds

A bond is an agreement in which the issuer receives capital and in return pays regular interest (the coupon) and agrees to pay the capital back at a pre-agreed date. A portfolio of fixed interest and index-linked gilts can be used to match the liability cashflows. However, achieving full cashflow matching with these assets is very difficult for a number of reasons:

- There is usually not enough money. The value of the pension fund's assets is insufficient to match every future cashflow.
- The pension fund needs a better return than can be achieved by holding only fixed interest and index-linked gilts. For example your Fund Actuary estimates that the Main Fund requires an investment return of 5.3% p.a. (without the employers paying deficit contributions) to restore the funding level to 100% by 2017. In this situation a pension fund needs to invest in higher returning investments (growth assets) to achieve at least this level of return.
- Building a portfolio of fixed interest and index-linked gilts that exactly matches cashflows is usually not possible due to the shape of the payments from such a portfolio and the lack of availability of fixed interest and index-linked gilts with a long enough term to maturity.
- In order to effectively hedge such risks, whilst allowing the assets to be deployed in growth assets to seek greater returns, a defined benefit pension fund can consider utilising swaps.

Swaps

A swap is an agreement between two parties to exchange a series of cashflows (either nominal i.e. linked to interest rates, real i.e. linked to nominal interest rates and inflation, or linked to inflation only) over a set period into the future. The purpose of the swap is to alter the cashflow characteristics of assets.

The simplest example of a swap is an interest rate swap. An interest rate swap involves a commitment by two parties to exchange cashflows based on a principal, or 'notional', amount. One party will make a series of payments calculated by applying a

fixed rate of interest to the notional amount and the other party pays back a stream of payments similarly calculated but generally using a floating rate of interest.

Swaps are individually tailored contracts ('over-the-counter' or “OTC”) although are increasingly required to be cleared centrally (with institutions performing a role similar to that of ‘exchanges’, like stock exchanges for example) and can be based on any terms agreed by the two parties involved. These can come in the form of interest rate swaps, real swaps and inflation swaps, where floating interest/inflation rates can be exchanged for a fixed interest/inflation rate.

In practice such investments are accessed through a professional third party LDI manager, who will typically use a variety of assets and investment instruments to protect against potential changes (positive as well as adverse) in the movements in the value of liabilities. These include: Gilts, index-linked Gilts, sale and repurchase agreements on Gilts (“Repos”), total return swaps (“TRS”), inflation swaps, interest rate swaps and swaptions

LDI considerations

The benefits of implementing a LDI strategy are purely from an investment perspective; a LDI strategy will reduce the unrewarded risks of inflation and interest rate changes versus the Fund Actuary’s valuation basis and reduce the potential volatility of the funding level. We reiterate again that your Fund Actuary has a particular way of establishing the discount rate which focuses more on broader investment market factors than purely considering long-dated interest rates as the starting point.

Further, a LDI strategy is purely an investment strategy decision, and whilst it may improve investment efficiency, will not reduce ongoing costs, and may in fact increase the governance burden in relation to the Transport Fund due to the need for higher training, understanding and ongoing monitoring standards required to effectively implement and oversee such an investment strategy. There will also be substantial set up costs: advisory (legal, actuarial and investment) and transaction costs in rebalancing the portfolio to a LDI investment strategy. Combined, these costs can be significant, particularly given the size of the Transport Fund.
It is also likely that a move to LDI within the investment strategy will increase the contribution levels required (in respect of both any deficit recovery and future service). This is because your Fund Actuary will likely need to reassess the valuation assumptions (potentially to a lower discount rate) to reflect the lower risk/ lower expected return investment strategy, although we would need to confirm with the Fund Actuary if LDI were a preferred route forward that the Council wish to consider.

We have not had this discussion at this time as, for the reasons highlighted in the paragraphs above, we do not believe that the implementation of a LDI strategy is likely to be the best way forward for any of the parties involved in administering or funding the Transport Fund.

It is also worth noting that LDI, as described in this section, will still leave the Transport Fund exposed to longevity risk i.e. the risk of

members living longer than is expected, which will also serve to increase the value of a defined benefit pension fund's liabilities. However, a partial liability buy-in will remove longevity risk, and we discuss this briefly in the next section.

Partial Liability Buy-in

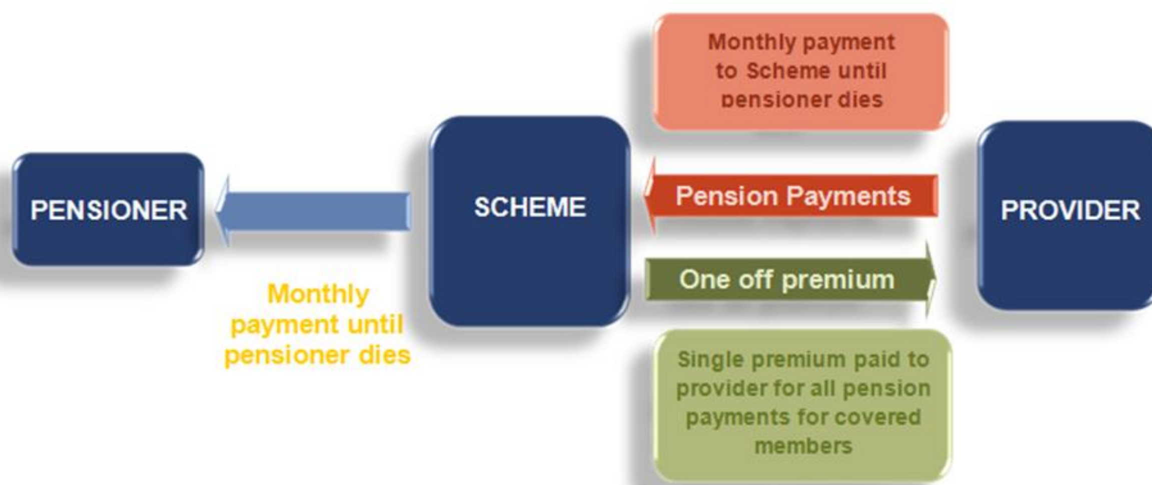
The buy-in concept

Insurance companies offer bulk annuity contracts that provide an income stream to match a given set of defined benefit pension fund benefit payments exactly, guaranteed for as long as the benefits are payable (i.e. removing longevity risk for the portion of the liabilities that are subject to the buy-in).

The Transport Fund still has a small number of active liabilities that remain subject to future accrual, and therefore it is unlikely to be economically feasible to buy-out all of the liabilities, which is why we focus on partial buy-in within this section. (In a buy-out scenario, all liabilities are transferred from the defined benefit pension fund to the insurer and the administering authority's / sponsoring employer's obligation is effectively dissolved. In a buy-in scenario, the defined benefit pension fund purchases a bulk annuity as an asset and the liabilities remain the responsibility of the administering authority / sponsoring employer – albeit they now have an asset that exactly matches the portion of the liabilities subject to the buy-in and will reflect any economically or demographic changes in the value of those liabilities).

A pensioner buy-in is a bulk annuity policy held in the name of the defined benefit pension fund, with the aim of precisely matching the benefit payments due for some or all of the pensioners. As noted, it is an asset of the defined benefit pension fund (rather than being assigned to members), therefore not favouring one group of members over another.

The graphic below illustrates how a pensioner buy-in works in practice:



Whether this route will be of interest will depend upon a number of factors:

- Security of members' benefits – expected to be high where those benefits ultimately fall back onto an administering authority with tax raising powers, all else being equal.
- Insurance Premium relative to the defined benefit pension fund's pensioner liability i.e. the cost – whilst there is increasing competition in the buy-in market, and we have seen some attractive pricing for some of our private sector defined benefit pension fund clients, it is doubtful that the pricing will be attractive for an administering authority, for example, with a potentially stronger covenant and the ability to take a much longer term view.
- Certainty with respect to the cost of pension provision – again, we refer you to our observations above.
- This is also essentially an investment decision.

Potential benefits

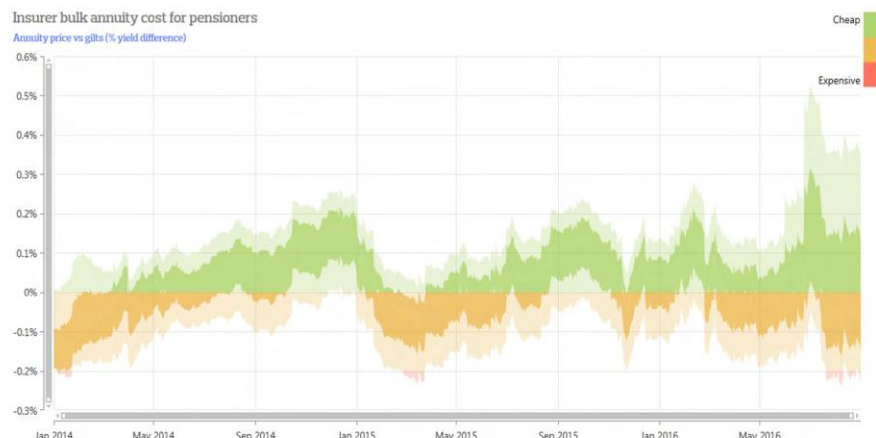
The key attractions of a pensioner buy-in are:

- It removes risks in relation to the selected members – such as investment, inflation and longevity risk.
- A buy-in is designed to provide an exact matching asset. With other investment strategies designed to match liabilities, the responsibility for making sure the "match" still works over time rests with the defined benefit pension fund. With a buy-in, the insurer takes on this responsibility, as well as the related investment management costs.
- Once a material proportion of the liabilities have been secured it can reduce some of the management time and costs associated with running the defined benefit pension fund (although not all).

Potential disadvantages

Some of the disadvantages and costs associated with a buy-in are:

- Implementing a buy-in would require transferring some of the existing assets (likely the majority) to an insurer; therefore there will be a significant change in the investment strategy.
- Loss of the potential for investment outperformance on the assets transferred to the insurance provider.
- Potentially higher price paid for the insurance policy than for providing the benefits from within the defined benefit pension fund (i.e. the insurance company's expected profit margin). Whilst buy-in pricing can currently be attractive, this is on an historic relative basis. This is illustrated in the chart below:



- Potential increase in the deficit within the defined benefit pension fund (and hence without additional capital the residual assets will need to work harder to amortise any deficit). Whilst our understanding is that the Transport Fund is currently well funded on a Gilts basis, for the reasons previously outlined, not least that there remain a small number of active members subject to future accrual, there remains the possibility that this option could still result in a funding strain – we would need to have more extensive discussions with the Fund Actuary in this respect if this route were of interest.
- On the basis that full buy-out is unlikely to be economically viable, there is a potential increase in risk relative to the defined benefit pension fund's residual liabilities (depending on the assets retained within the residual portfolio).
- Legal advice would need to be undertaken; this cost is variable but is likely to be substantial.

Buy-in considerations

A buy-in may look attractive in terms of historical pricing it still represents a large cost to remove interest rate, inflation and longevity risk in absolute terms. However, buy-in is also purely an investment strategy decision, and whilst it may improve investment efficiency, will not reduce ongoing costs.

There will also be substantial set up costs: advisory (legal, actuarial and investment) and transaction costs in rebalancing the portfolio to accommodate any potential buy-in. Combined, these costs can be significant, particularly given the size of the Transport Fund Further, as we have already noted, although the Transport Fund is closed, there are still active members and therefore ongoing future accrual, so it is not likely to be practical or cost effective to buy-out or buy-in all of the liabilities, for example, which would remove the ongoing governance requirement.

Transport Fund Repatriation into the Main Fund

Repatriation of the Transport Fund into the Main Fund

One of the potential options for the Council to consider is repatriating the Transport Fund into the Main Fund. The considerations for this course of action include;

- Administering Authority and other employers within the Main Fund having to take on additional responsibility / potential financial liability.
    - We have had sight of provisional legal advice from Pinsent Masons LLP provided to the Council which states that the repatriation should not disadvantage employers in the Main Fund and that a guarantee in respect of any exit charge due from the sponsoring employer of the Transport Fund will help mitigate this potential outcome.
- Repatriation process and documentation.
- Attractiveness of this option for the current sponsoring employer and other employers within the Main Fund.
    - It is essential that the contribution rate calculated by the Fund Actuary continues to be sufficient to reflect the risk

premium justified by the strength of the covenant of the sponsoring employer of the Transport Fund compared to that of the Administering Authority and the other employers in the Main Fund, reflects the maturity and liability structure of the Transport Fund, and no current or future funding strain is imposed on the Main Fund as a result of any repatriation.

- Tax implications and establishment costs, including further advisory fees.
- Change in investment strategy.
- Legal, administrative and actuarial considerations will play an integral role in assessing the feasibility of this option.

Administering Authority's position and the position of other employers in the Main Fund

We have been informed that in the event of the failure of the sponsoring employer of the Transport Fund, National Express, the Administering Authority may be required to take on responsibility for the liabilities, including any past service deficit. Therefore, if this is correct, it is difficult to see any impediment to repatriating the Transport Fund into the Main Fund due to this potential consideration.

However, we have had sight of provisional legal advice from Pinsent Masons LLP provided to the Council which states that the repatriation should not disadvantage employers in the Main Fund and that a guarantee in respect of any exit charge due from the sponsoring employer of the Transport Fund will help mitigate this potential outcome.
If the Council is in any doubt as to the accuracy of the situation that they have explained to us, the Council should take legal advice in this respect, which we are not able to provide, before proceeding.

Repatriation process and documentation

The asset allocation of the two Funds can be found in Appendix A. The table below provides information on the common investment managers between the Main Fund and the Transport Fund (who would be affected by any repatriation). We also provide, based on our initial estimates and conversations with the investment managers, the practicalities of novating assets, any anticipated costs (please note that these are sourced from the investment managers and the Council should satisfy themselves that these will be honoured prior to any repatriation) and the feasibility of doing so:

Manager / Fund	Held within the Main Fund?	Held within the Transport Fund?	Novation possible?	Potential cost of moving assets
Baillie Gifford Global Equity	Yes	Yes	Yes	Minimal/none
Baillie Gifford UK Equity	Yes	Yes	Yes	Minimal/none
Schroder Property Fund	Yes	Yes	Yes	Minimal/none
GSAM Bonds	Yes	Yes	Yes	Minimal/none

The initial indication is therefore extremely good – our initial discussions with each of the investment managers would seem to indicate that the repatriation of the Transport Fund assets into the Main Fund assets can be achieved on a cost efficient basis. The big risk, and therefore cost, here, would be the need to sell and then repurchase units in each manager's fund and / or the requirement to pay Stamp Duty Reserve Tax if there were deemed to be a change in beneficial owner of the investment. Based on the investment managers' guidance in this respect, we currently do not believe that this is the case.

What is Novation? Novating or re-registering the existing assets of a defined benefit pension fund is essentially the movement of assets from one fund/arrangement to another without changing the underlying fund, structure, and most importantly the beneficial ownership.

Although this cannot be guaranteed, at this stage we have spoken to the relevant investment managers for the Transport Fund who have indicated that this can be done with minimal to no cost, although will take time due to the legal and operational aspects involved. The exercise would in essence be a reversal of the October 2012 decision to split the Main Fund and Transport Fund assets.

We do not anticipate that the investment managers will explicitly charge for the novation and transfer of the assets. However, certain investment managers have been known to charge clients for such tasks in the past, particularly if they are required to obtain legal advice on any novation agreements or other non-standard documentation that is required as a result of the transfer. To date, such repatriation of LGPS funds are relatively uncommon from the investment managers' perspective.

We therefore recommend that each manager is asked to formally confirm in advance to the Council whether any costs (administrative, custodial, broker or legal) will be incurred.
The key costs of the repatriation from an investment perspective will therefore be the consultancy costs associated with managing the repatriation of assets.

However, in order to repatriate the assets to the Main Fund, the Transport Fund and Main Fund may be required to complete a significant amount of documentation.

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However, in order to repatriate the assets to the Main Fund, the Transport Fund and Main Fund may be required to complete a significant amount of documentation.

Attractiveness for the current sponsor and other employers within the Main Fund

In order for the repatriation of the Transport Fund into the Main Fund to progress and in order to seek to protect the interests of the Council and the other employers within the Main Fund, so far as it is possible to do so, it is important that the new sponsoring employer repatriating to the Main Fund commits to paying a realistic level of contributions within the Main Fund.

In large part, this will depend upon the terms that are negotiated and ultimately agreed between the Council, National Express and their respective actuarial and investment advisers.

Specifically, it is essential that the contribution rate calculated by the Fund Actuary continues to be sufficient to reflect the risk premium required, and justified, by the strength of the covenant of the sponsoring employer of the Transport Fund compared to that of the Administering Authority and the other employers in the Main Fund, reflects the maturity and liability structure of the Transport Fund and that no current or future funding strain is imposed on the Main Fund as a result of the repatriation.

However, we have had sufficient initial discussion with your Fund Actuary to believe that a mutually acceptable agreement can be reached. Again, the Council may wish to speak to, and agree with, it’s other advisers that this is indeed the case before proceeding.

Tax implications and establishment costs

It is important that the Council obtains tax advice ahead of time and prior to novation. This will provide an indication as to whether any tax obligations or stamp duty costs are incurred. From our conversations with the investment managers to date, they have advised that no stamp duty will be paid as there is no change in the beneficial owners of the assets.

Aon Hewitt is not able to give tax advice and we recommend that the Council seeks further advice from the investment managers and its tax advisors if in any doubt.

Investment strategy

Following novation of the assets, the repatriated assets of the Transport Fund may need to be re-organised to ensure that they align with the Main Fund's chosen investment strategy. This re-organisation process does not need to occur immediately on "day 1" though, and can be dealt with once the other aspects of the repatriation have been completed.

However, given the Main Fund dwarfs the Transport fund with respect to assets and liabilities, we would expect the resulting investment strategy to be very similar (if not initially identical) to that of the Main Fund investment strategy. As part of any rebalancing, there may be the opportunity to revisit the composition of the Return Seeking assets and Liability Matching assets.

Timing of a transfer

One legal consideration which may need to be posed to the lawyers is whether it will be necessary for the transfer of assets to take place on the same date that the Transport Fund’s assets are legally repatriated into the Main Fund or whether this transfer can take over a period following the repatriation.

This has timing implications because, in our past experience, a transfer or novation of assets can only happen on a standard trade date (e.g. the last working day of a given month). These tie in to operational considerations of all aspects of the receipt of the required documentation.

Legal issues relating to investments

If repatriation is the preferred route, we recommend that the Council check the following with their lawyers:

1. That there is no change in beneficial ownership if the assets are transferred to the new arrangement. If the new arrangement will result in a change in beneficial ownership, we will have to examine whether stamp duty becomes payable on some of the equity holdings of the Transport Fund.

2. The Council may wish to ask their lawyers to check their powers in relation to the Scottish Local Government Pension Scheme Regulations to ensure that the proposed repatriation can take place.

Potential cost savings

Potential benefits of repatriating the Transport Fund into the Main Fund include the expectation of cost, time and governance savings. These can be broken down into:

- Investment: We expect that the cost reduction here would be the avoidance of duplication for investment strategy reviews (c. £25,000 per review as a guide), asset allocation advice and general investment matters. Given the nature of this work is dependent on the scope of the projects this is difficult to quantify but we believe that the potential cost savings here would be material.
- Custodial: We have liaised with the custodian and whilst they have not provided us with a monetary cost saving (due to client confidentiality) they have mentioned that the cost savings would be two parts; the Council would no longer pay an account charge or performance change for the Transport Fund accounts, although this would be mitigated if the Council wanted to have separate benchmarks for the Main Fund and Transport Fund assets within the same account. In addition, Northern Trust has indicated that there would be some transactional costs for the transition to repatriate the Transport Fund into the Main Fund.
- Northern Trust have noted that a reasonable expectation for the cost saving per annum would be to annualise the Standing Change and IRAS Performance Measurement fee on the last quarterly invoice for the Transport Fund.
- Administrative: The administrative costs are difficult to quantify as the time saved in Committee meetings, discussions on two separate sets of investment and actuarial reports and time spent by the Officers on the duplication of work is difficult to assign a monetary value to.
- Actuarial: Given that only one actuarial report would be required and that duplication of general reporting will be eliminated there will clearly be cost savings in this respect.

Key considerations

- The legal considerations are the most important; a legal review might need to be undertaken, according to the Council's discretion, to understand whether repatriation is possible. If it is not currently possible, it may be possible to change the Scottish LGPS Regulations, although the time and cost of doing so may be a potential barrier.
- Provisional legal advice from Pinsent Masons LLP provided to the Council states that the repatriation should not disadvantage employers in the Main Fund and that a guarantee in respect of any exit charge due from the sponsoring employer of the Transport Fund will help mitigate this potential outcome.
- Should the investment managers or lawyers state that it is not possible (or the costs of doing so would exceed the benefit) to novate assets, then the expected costs of repatriation would be significant. In addition to advisory costs there could potentially be transition costs (associated with the selling and repurchasing of units) of up to 1% for the equities and bonds and more for the property units.
- The Transport Fund represents c. 2% of the combined Tayside Pension Fund assets and the duplication of certain functions (actuarial valuation, investment reporting, and custody costs) represents an inefficient use of capital and time for the Council. Supported by the fact that the Transport Fund shares commonality in advisors, investment managers and custodian,

repatriation represents a beneficial route for the Council.

- The Transport Fund's sole employer, National Express, would be likely to involve their advisor KPMG in any discussion. This is not unexpected and will lengthen proceedings and add to costs, although, based on discussion with the Main Fund and Transport Fund's Actuary there do appear to be some advantages including the removal of accounting responsibility for the Transport Fund's liabilities on their balance sheet on their part and in terms of offering fixed % contributions of a diminishing payroll over the remaining active life of the Transport Fund in order to effectively discharge their liability over the Transport Fund in the short, rather than over the medium to long term.
- However, it is essential that the contribution rate calculated by the Fund Actuary continues to be sufficient to reflect the risk premium justified by the strength of the covenant of the sponsoring employer of the Transport Fund compared to that of the Administering Authority and the other employers in the Main Fund, reflects the maturity and liability structure of the Transport Fund and that no current or future funding strain is imposed on the Main Fund as a result of the repatriation.

Summary and Recommendations

Summary

In this report we have set out three options for the Transport Fund. Of the three options under consideration, two were essentially investment decisions around strategy (Liability Driven Investment and partial buy-in) and only the repatriation of the Transport Fund into the Main Fund represents a material change that would bring the desired benefits of long term cost reduction and governance savings.

We believe that the special conditions affecting the Transport Fund and Main Fund make repatriation the most beneficial option.
This is because:

- The small size of the Transport Fund relative to the Main Fund makes this a special case in the context of considering repatriation.
- The overlap between the investment managers and funds utilised by the Transport Fund and the Main Fund again make this a special case in the context of considering repatriation.
- The fact that fund repatriation on the asset side would simply reflect a reversal of the asset separation that took place in 2012.
- The expectation that the legal actuarial, investment and other advisory costs will be reduced substantially compared to the other two options.
- The simplification of the governance arrangements, and hence cost and governance savings that such a repatriation would achieve in terms of both the time of the Committee, the Officers and their advisers.
- That the governance burden of the Council will be reduced, increased efficiencies and economies of scale will be achieved in the management of the two funds.
- That the interests of the members of the two Funds and those of the Council will not be compromised (based on our current

understanding and notwithstanding the further legal and actuarial advice on the aspects of Transport Fund repatriation that the Council might wish to obtain and that we have previously noted).

Recommendation

Notwithstanding any legal review of the Scottish LGPS regulations that the Council may require, we believe that a repatriation of the Transport Fund inti the Main Fund is feasible and that the costs incurred would be minimal.

We also believe that the cost savings, both in monetary terms and time saved, would outweigh any initial establishment costs.
If in any doubt the Council should seek further legal and actuarial advice, as appropriate, to ensure that Transport Fund repatriation is an achievable and cost effective way forward for both the Transport Fund and the Main Fund, and all of the various contributing employers.