West Yorkshire Pension Fund (WYPF) Response to the Call for evidence on the future structure of the Local Government Pension Scheme

1. Background

1.1 On 16 May 2013, the LGA and DCLG held a roundtable event on the potential for increased co-operation within the Local Government Pension Scheme, including the possibility of structural change to the current 89 funds. 25 attendees represented administering authorities, employers, trade unions, the actuarial profession and academia. There was a full discussion of the possible aims of reform and the potential benefits of structural change, together with the further work needed to provide robust evidence to support emerging options.

2. Key Points

2.1 Many of the issues and concerns raised by the call for evidence had already been identified by the Working Groups preparing for the (Shadow) Scheme Board. WYPF would therefore recommend that the Scheme Board should be charged by the minister (and appropriately resourced) to collate, analyse and undertake the further work that will clearly be necessary as a result of the call for evidence, as a matter of urgency.

2.2 WYPF is firmly of the view that all action and reform must be based on clear and unequivocal evidence, and for that reason there will be a considerable data collection and verification exercise required. To ensure the benefits of reform are fully achieved it will be essential that the data is independently verified.

2.3 The success of any structural reform will depend on maintaining local accountability and managing the cost of change. There is clear evidence that changing managers has significant cost implications, and generally results in a period of poor performance, factors which must be taken into account.

2.4 Progress on a number of the objectives can be achieved more quickly by encouraging participation in the joint working and national procurement initiatives already under way. This could be enhanced further by amendments to the investment regulations to make it clear that authorities can invest jointly, and on behalf of another authority.

2.5 As part of its contribution to the collation of hard evidence WYPF, together with Greater Manchester Fund, has commissioned research by State Street who measure the performance of LGPS funds, which is submitted as part of the WYPF response.

2.6 Responses to the five questions posed are in Appendix 1 to this document.

3. Objectives of the Call for Evidence

3.1 The call for evidence sets out the following objectives for structural reform:

High level objectives

Dealing with deficits

Improving investment returns

Secondary objectives

To reduce investment fees

To improve the flexibility of investment strategies

To provide for greater investment in infrastructure

To improve the cost effectiveness of administration

To provide access to higher quality staffing resources

To provide more in-house investment resource.

3.2 Each of these is considered in the next paragraph, but the shortage of useful accurate data limits the strength of any conclusions at this point in time. For example, the SF3 data published by DCLG shows a limited correlation between size and cost. A cursory review of the data, however, leads to the conclusion that the costing of activities within certain authorities may warrant some improvement.

4. Responses to Each Objective

4.1 Dealing with Deficits.

4.1.1 Deficits within the LGPS have been a fact of life for many years, and, while they have received greater publicity in recent times, have their roots in decisions made up to 30 years ago. In the 1980s the index linking liability was transferred to the scheme at the same time as employers were taking contribution holidays, as many funds were bumping up against an Inland Revenue maximum funding limit. In the 1990s funding was reduced to 75% by regulation, and then the ACT recovery on income was lost. After that the bond yield on which the liability is evaluated has fallen to historic and unsustainable lows. Simultaneously average life expectancy has improved.

4.1.2 This long term problem therefore needs a long term solution. Most funds have a deficit recovery plan of over 20 years, which is entirely appropriate. This is required by regulation, and is set out in each fund's Funding Strategy Statement (FSS).

4.1.3 Any consolidation of funds would not change this situation, as the deficit would follow the employer in any case.

4.1.4 It is also important to remember that the average deficit of 25% (Hymans Robertson estimate at 2010) is a position vastly superior to any other part of the public sector, where the deficit is 100%.

4.1.5 WYPF’s deficit at 2010 was 7%.

4.2 Improving investment returns.

4.2.1 Improving investment returns is something that is on all fund’s agenda, but little hard data is available on what will in fact deliver improved returns. For this reason WYPF, together with Greater Manchester Fund, has commissioned research by State Street who measure the performance of LGPS funds, which is submitted as part of the WYPF response.

4.2.2 While it is evident from this research that size is not a determining factor in relation to return, it is true that the level of risk, or consistency in delivering returns does have a relationship with size. The conclusion must be that a more efficient portfolio is the likely result of a larger fund.

4.2.3 It is also evident that internally managed funds, such as WYPF, perform better than externally managed funds, and with a lower level of risk. This is helped by their ability to invest for the long term, and is evidenced by the much lower turnover of internally managed funds, which, of course, contributes to the lower cost of the operation. The better performance is before taking into account the lower cost, which State Street estimate to be between 15 and 25 basis points (bps) per annum, but some research puts much higher than this. Even at 15bps per annum is significant, and move such funds close to the top of the league table, before considering the lower risk and calculating portfolio efficiency. There is always concern that attracting talented managers would be impossible within the local government structure. However, this is not necessarily the case. If the management of the fund is seen as what it is, a major service the authority must deliver, not just a minor part of the finance department then this should not be an insurmountable problem. No investment management company would have the investment management operations reporting to the Director of Finance; there would be a separate operations director responsible, and that is how funds should be managed.

4.2.4 Simpler fund structures also show better returns. There is an inverse relationship between the number of managers and investment returns. It is likely that this may relate to the advice received. Where an independent advisor is used structures tend to remain simpler and the result is better returns. This may be a further contributing factor to the excellent results of internally managed funds, which in general are much less dependent on consultants for advice, and are likely to use an independent advisor.

4.2.5 Working with peers on a variety of joint projects can also assist in improving returns, as a larger client always get more attention from a contractor. This can also be a way of generating more and better investment opportunities. An example of this is Investing4Growth, a joint initiative between a number of funds, which has its own website

4.3 To reduce investment fees.

4.3.1 Reducing investment fees is very much a secondary objective, as fees are generally a relatively insignificant amount in relation to the return sought.

4.3.2 The points made in paragraph 4.2 are the key one’s to consider here, with this kept in the back of the mind at all times.

4.3.3 It is also important to consider the hidden costs, as, for example, there is a considerable cost borne by the fund if the portfolio is being turned over too much, but this cost is not measured or reported, other than in lower performance.

4.4 To improve the flexibility of investment strategies.

4.4.1 While flexibility may seem desirable, and internally managed funds can successfully manage this, there is a large degree of risk that it will result in excessive concern with the short term. It is clear that managers with short term investment horizons do not deliver the long term performance required by a pension fund. Considerable caution is required, and such flexibility should be dependent on a simple and inexpensive efficient method of making any changes to the portfolio being available.

4.4.2 Realistically, this requires excellent governance arrangements to be in place, and professional staff with the delegated power to implement changes efficiently and effectively.

4.5 To provide for greater investment in infrastructure

4.5.1 Infrastructure is just one element of a portfolio, which will be a part of an efficient portfolio designed to meet pension liabilities when they fall due. Providing greater investment in infrastructure can never be a useful objective for a pension fund, which is there to ensure its members receive the benefits when they are due so that they do not become a burden on the state.

4.6 To improve the cost effectiveness of administration.

4.6.1 Larger organisations clearly are in a position to make savings on administration, and with over 300 employers and 250,000 members WYPF is in this category, having a very low and falling administration cost. However, pensions administration is a small part of most local authorities, and, if there are savings to be made by consolidation, it is likely that there are bigger savings to be delivered in other areas.

4.6.2 Consolidating pension funds purely to achieve this would reduce local accountability, and potentially create unaccountable bodies with poor cost control. The SF3 data, published with the call for evidence, shows that a fund not under direct political control is less likely to control its costs effectively.

4.7 To provide access to higher quality staffing resources.

4.7.1 WYPF is unaware of any staff quality issues in its dealings with other funds, and has itself a very efficient and effective administration team.

4.7.2 As far as the investment staff are concerned, the comments in 4.2 above apply, and staff are available when a fair package is offered.

4.8 To provide more in-house investment resource.

4.8.1 This can be achieved by all authorities if they so chose. Almost all authorities already have their own staff managing their cash and debt portfolios. Managing bonds is merely the other side of those transactions. Once the journey has begun the opportunity to control costs increases rapidly, and there is a substantial increase in local accountability.

4.8.2 The key to this developing is having good governance arrangements, and political support to develop the service and deliver the available cost savings.

4.8.3 WYPF would be very willing to work with any authorities who wish to go down this route.

Appendix 1

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

A high level of accountability to local taxpayers is best achieved through the local democratic arrangements, as local taxpayers are used to holding councillors to account. Removing this direct link would result in a significant loss of local accountability. A regulatory requirement for full separation of pension fund accounts, at present only the bank accounts are required to be separate, would improve the data quality, and ensure decisions can be made based on facts. A regulatory requirement for those serving on, and officers advising, decision making bodies would ensure improved governance, which is key to promoting stronger investment performance. It may be prudent to include in such regulation a requirement for members of such bodies to be appointed for a minimum term, perhaps four years to tie in with the electoral cycle.

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

In considering the high level objectives it is perhaps useful to go back to the principal reason for the fund, which is to defer an individual's earnings during their working life to their retirement years so that they are not dependent on the state. The total cost of the scheme must be monitored, and the new scheme governance arrangements will put that in place. However, the principal driver of the cost, by definition, will be remuneration levels, and this is outside the scope of these discussions. Comments on the high level objectives referred to in the Call for Evidence are included in the main body of the response.

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

The most successful of the existing funds are those with full and comprehensive local governance arrangements, with full participation of all interested parties. Regulatory requirement of full participation at the local level is the best way to achieve the high level objectives. Please refer to the comments in Question 1.

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

Improved governance as referred to in Questions 1 and 3 above should ensure that the secondary objectives are properly addressed, and indeed generally better management of funds. Introducing too many secondary objectives will cloud the issue, and make it more difficult to evaluate the benefit of any changes introduced.

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

Proper separation of accounts will be necessary in order to obtain clean data on funds. There is also a need for improved costing of activities within accounts, as it is evident that outsourcing frequently does not deliver the anticipated savings when, for example, internal recharges have not been appropriately assessed. Once again, if the reforms to governance arrangements referred to in Question 1 are implemented the result will be better data available on individual schemes, allowing national collation and analysis which will feed back into the governance process.