West Yorkshire Pension Fund (WYPF) Response to the Open consultation on Local Government Pension Scheme: opportunities for collaboration, cost savings and efficiencies

1. Executive Summary

1.1 Maximising Savings

In order to maximise investment returns and cost savings WYPF would support the development of internal management widely within the LGPS (see paragraph 2.12 of the consultation document). Both the Hymans Robertson report and the experience of WYPF (extending over 30 years) demonstrate consistent superior investment returns and lower costs. Amendments to the Investment Regulations to simplify the basis on which Funds could collaborate to extend internal management would enable savings to be achieved more rapidly.

1.2 Data Quality

WYPF is firmly of the view that all action and changes must be based on clear and unequivocal evidence, and for that reason accurate and complete data should be collected as a matter of urgency, as the extrapolated data in the Hymans Robertson report could result in incorrect conclusions. To ensure the benefits and savings are fully achieved it is essential that the data be verified independently.

1.3 Q1 Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments?

There is no doubt that Common Investment Vehicles (CIVs) have a part to play in achieving economies of scale for some funds and in particular asset classes. However, it cannot be assumed that this will always be the case, as in many instances there will be simpler and cheaper options available that are capable of delivering the savings. This is almost certainly going to be the case for passive investment in equity markets, because, as identified in the Hymans Robertson report, it is necessary for there to be private sector schemes in the same pool in order to maximise the available 'crossing' benefits. In addition there is the issue that only pension funds may own units in a life fund, the usual basis on which passive funds are set up.

1.4 Q2 Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?

WYPF supports this proposal, as local accountability is seen as key to the long term sustainability of the scheme, and indeed the principle of local accountability is supported by paragraph 3.1 of the consultation document itself. WYPF does, however, believe that part of the asset allocation decision should include determining the split between active and passive investment.

1.5 Q3 How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?

It is not possible to predetermine the number of CIVs that will be required, as a CIV should only be established when absolutely necessary. Where the economies of scale or cost saving can be achieved by a simpler method that should be implemented, as each CIV will of necessity add to the financial, regulatory and governance costs of running the scheme. Collaboration will, in many instances, deliver the required scale and saving without incurring any additional costs.

1.6 Q4 What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?

In all instances the simplest and cheapest solution should be sought, beginning with collaboration. Where a CIV is needed, the type of CIV should be determined by the objectives to be achieved, rather than by an ‘off the shelf’ solution which may not be ideal. The London CIV should be treated as a pilot, and the creation of further CIVs discouraged until the lessons learned from that experience can be shared.

1.7 Q5 In light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson’s evidence on aggregate performance, which of the options set out above offers best value for taxpayers, Scheme members and employers?

WYPF would support the ‘comply or explain’ approach, something which all well governed funds should already be doing. WYPF believe that the basis of compliance should not simply be a consideration of active or passive management, but a comprehensive review of investment returns after all costs against the chosen benchmark, and over periods that are appropriate to the asset class being considered. (Investment consultants will advise a review of an equity mandate after three years, which as economic cycles tend to be seven to ten years is clearly inappropriate). WYPF would support extending the process to require funds to explain, if they do not manage funds internally, why, as the evidence, in both the Hymans Robertson report and the WYPF experience, demonstrates this to be both cheaper and deliver improved investment returns.

2. Background - National

2.1 In 2010 the Government commissioned Lord Hutton to chair the Independent Public Service Pensions Commission to review public service pensions and to make recommendations on how they might be made more sustainable and affordable in the long term, while being fair to both taxpayers and public sector workers.

2.2 The report was published on 10 March 2011 and formed the basis for major reforms to all public service pension schemes. The new Local Government Pension Scheme which came into effect on 1 April 2014 is the first scheme to be introduced following Lord Hutton's principles for reform as enacted in the Public Service Pensions Act 2013.

2.3 Lord Hutton highlighted the collaborative approach being taken by funds within the Local Government Pension Scheme and recommended that the benefits of co-operative working between local government pension funds and opportunities to achieve efficiencies in administration more generally should be investigated further.

2.4 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.

2.5 The objectives for reform identified at the round-table fed into a call for evidence on the future structure of the Scheme, which ran from 21 June to 27 September 2013. This asked respondents to set out the data required to enable a reliable comparison of fund performance and to consider how the administration, management and structure of the Scheme might be reformed to address the objectives identified at the round-table event. These objectives included reduced fund deficits and improved investment returns, as well as reduced investment fees and administration costs, greater flexibility of investment, especially in infrastructure and more use of better in-house investment management.

2.6 133 responses were received to the call for evidence. To support the call for evidence, the Minister for Local Government and the Minister for the Cabinet Office commissioned additional analysis using the Contestable Policy Fund. Following a competitive tender process, Hymans Robertson were selected to establish the aggregate performance of the Scheme by asset class and to provide a detailed cost-benefit analysis of three potential options for reform:

- Establishing one common investment vehicle for all funds
- Creating five to ten common investment vehicles for fund assets
- Merging the existing structure into five to ten funds

2.7 The analysis set out the costs and benefits of each option; the time required to realise savings; the practical and legal barriers to implementation and how they might be addressed. Hymans Robertson's findings have been reflected in this consultation, alongside the call for evidence responses and analysis by the Shadow Scheme Advisory Board.

2.8 Because of time constraints on producing the report Hymans Robertson were obliged to extrapolate data from a sample of funds. Obviously there are significant risks in making such important national policy decisions on the basis of doubtful information. Further data collection and verification should be undertaken prior to final decisions being reached.

3. Background – West Yorkshire Pension Fund

3.1 WYPF is one of the largest LGPS funds, with over 250,000 members and more than 350 employers. It presently manages investments with a value in excess of £10 billion. All main asset classes are actively managed internally, and it has a consistently good track record of investment returns stretching back over 30 years. This has been achieved with a cost base of less than 1.4bps, a quarter of the cost of passive management, and with lower turnover than a passive fund, hence lower transaction costs.

WYPF Relative Performance

Period (Years)	WYPF %	Benchmark %	Relative %	Universe %	Relative %	Rank
10	8.4	7.9	0.5	7.8	0.6	13
20	7.8	7.3	0.4	7.2	0.5	10
25	8.7	8.3	0.3	8.2	0.4	16
27	8.7	8.2	0.4	8.2	0.4	8
30	10.1	9.6	0.5	9.5	0.5	n/a
35	11.2	10.7	0.5	10.6	0.5	n/a
36(longest)	11.7	11.1	0.6	11.0	0.6	n/a

Source: The WM Company

3.2 According to the Hymans Robertson report the cost of active management is 41bps. If we assume that is overstating the cost, and adjust the WYPF figures by just 30bps to reflect what other funds have to pay away to third party managers that would move WYPF up the rankings to 3rd over 20 years, 2nd over 25 years and 6th over 27 years.

3.3 Having reduced the discount rate to reflect current conditions and increased life expectancy in accordance with the latest research, WYPF was 96% funded at the 2013 actuarial valuation, an improvement of 3% from the position at 2010.

WYPF Statistics

	2007	**2010**	**2013**
Membership			
- Active	93259	97071	89273
- Deferred	55937	58534	74829
- Pensioners	55138	62758	71953
Funding Ratio	90%	93%	96%
Future Service Rate	13.2%	13.8%	14.3%
Discount Rate	6.9%	7.0%	5.6%
Deficit Recovery Period	22 Years	22 Years	22 Years
Life Expectancy at 65 Male/Female (Years)	20/24	21.7/23.9	22.4/25.3

3.4 As a large fund, WYPF benefits from economies of scale on administration costs, and has one of the lowest costs per member. WYPF is presently working towards a joint service with another administering authority which will reduce this even further. This low cost is not at the expense of service quality, as WYPF is independently monitored against service standards to maintain its ISO9001 registration.

3.5 As a result of these factors WYPF has been able to maintain stable contribution rates for virtually all employers. WYPF can, therefore, be considered a successful fund by any measure.

4. Objectives of the Consultation and Related Issues

4.1 WYPF considers that the consultation should identify a variety of opportunities for funds to both improve investment returns and reduce costs, and that it should identify best practice within those funds which have been successful in meeting their objectives and require all funds to improve, but particularly those which have consistently underperformed. WYPF would not support a compulsory move to passive investment, as that would result in a significant drop in investment returns as well as an increase in costs for this fund. This unnecessary shortfall would then have to be recovered from the West Yorkshire taxpayers.

4.2 The ultimate objective of this process is to manage and eliminate fund deficits which have built up over the last 25 years. It is important to provide some context to this, including noting that action now will enable the issue to be addressed in the foreseeable future, supporting the action already taken by the Government to address the issue, the introduction of the new scheme on 1 April 2014.

4.3 The consultation points out that the cost to the taxpayer has increased substantially since the 1990s. It should be noted that in that time the taxpayer benefitted from the transfer of the liability for pensions increases to the funds, the compulsory reduction of funding levels to 75% in 1992, and the loss of the Advance Corporation Tax recovery in 1997. Subsequently there have been three factors that have not been of benefit to the taxpayer, but have increased the fund deficits, two market crashes and increasing longevity.

4.4 The Government have already taken action following the Independent Public Service Pension Commission review by introducing a revised scheme with sustainable benefits.

4.5 The data obtained by Hymans Robertson and used for the purpose of their report and this consultation was based on a limited survey (only 18 out of 89 funds), or obtained from CEM, which once again is not based on a full set of data. The accuracy of the data is therefore uncertain, and therefore any policy decisions could be risky. WYPF would recommend that the Shadow Scheme Board be charged with obtaining complete and accurate data set from funds as a matter of urgency, and certainly before final policy decisions are reached, so that policy can be based on a complete and accurate data set.

4.6 The consultation points out that savings are already being generated by procurement frameworks and collaborative working. WYPF would recommend that DCLG support and encourage these developments, including making regulatory amendments, to enable these initiatives to be brought forward and extended to maximise savings as soon as possible.

4.7 It is disappointing to note that the report and the consultation focus on cost savings, and reducing all returns to the average. WYPF would recommend that the focus of policy should be on considering net investment returns, which would allow the maximum contribution to the public purse, and seek to improve those funds which underperform, while retaining the value generated for the taxpayer by those funds which consistently outperform. Public policy should be to obtain maximum value for the taxpayer.

4.8 In their report Hymans Robertson do not give a definition of what they mean by passive management, and how they chose the indices for comparison. In what they have done they have made some fairly broad assumptions which in the context of today's investment market could be completely inappropriate. For example, to comply with the Regulations and statutory guidance each fund is required to set its own personalised benchmark in order to have an investment programme which matches its liability profile. This could well mean that although a fund has an allocation to UK Equities the investment objective is to generate income, not match the index. The conclusions reached by the Hymans Robertson report on how funds have performed could therefore be completely spurious.

4.9 Any compulsion by regulation would amount to a Government investment decision, responsibility for which would then not rest with the locally accountable elected Members.

4.10 Passive management has a negative impact on the whole capital allocation system. This is most easily demonstrated in the corporate bond market where failing companies raising increasing amounts become a significant part of the index. Long term, this applies to the equity market too, as by definition the index contains a company until it fails. This has implications for the whole capitalist system.

4.11 LGPS funds have been leaders in the development of Environmental, Social and Governance policies over many years, to the benefit of the market as a whole, over two thirds by value being members of the Local Authority Pension Fund Forum. Compulsory passive management would remove the ultimate sanction of selling the shares in a company where engagement had failed.

4.12 Neither the report nor the consultation gives any consideration to the role of the major investment consultants, who have exercised considerable influence over how the externally managed funds have invested in recent years. This will be particularly true for those funds with minimal internal knowledge and skill. It would be useful to know whether there is a correlation between the (expensive as identified in the HR report) advice obtained and the level of performance. Internally managed and larger funds tend to use independent advisors.

5. Q1 Do you agree that common investment vehicles would allow funds to achieve economies of scale and deliver savings for listed and alternative investments?

5.1 There is no doubt that Common Investment Vehicles (CIVs) have a part to play in achieving economies of scale for some funds and in particular asset classes. However, it cannot be assumed that this will always be the case, as in many instances there will be simpler and cheaper options available that are capable of delivering the savings. Joint working or delegated functions could deliver even greater savings, as there would be almost no additional cost to offset the savings.

5.2 Governance, regulation and administration will add to the cost and complication of any CIV, and could indeed consume all the savings that were expected. For this reason the simplest solution to joint arrangements should always be sought.

5.3 It is unlikely that a single solution to joint working will be the best solution in all cases, and the method or vehicle should be determined after the specific objectives of that cooperation arrangement have been set.

5.4 There will be a variety of difficulties in using a CIV for passive investment in equity markets. As identified in the Hymans Robertson report, it is necessary for there to be private sector schemes in the same passive pool in order to maximise the available ‘crossing’ benefits. In addition there is the issue that only pension funds may own units in a life fund, the usual basis on which passive funds are set up. It is therefore unlikely that a CIV would be possible or appropriate; a simple framework agreement is likely to deliver all the benefits without additional financial or governance costs.

5.5 For unlisted investments it is possible that CIVs could deliver savings, as the benefit of scale could assist in the negotiation of lower fees. However, simple joint working with a lead authority negotiating could achieve the same result with no additional cost or overhead. This process is already under way with some managers. A good example is the Investing for Growth initiative undertaken by a number of Northern funds, where one fund reviewed each investment on behalf of all, and negotiated a common fee.

5.6 Because of capacity constraints with unlisted investments, the CIV approach would mean a considerable number would be required, and the resulting overhead could well consume the savings. A simpler joint approach, delegation or lead authorities could well be more efficient in terms of generating savings.

5.7 The London CIV should be treated as a pilot, and the creation of further CIVs discouraged until the lessons learned from that experience can be shared.

6. Q2 Do you agree with the proposal to keep decisions about asset allocation with the local fund authorities?

6.1 WYPF supports this proposal, as local accountability is seen as key to the long term sustainability of the scheme, and indeed the principle of local accountability is supported by paragraph 3.1 of the consultation document itself.

6.2 Good governance is the key to the long term performance and success of a fund. This means there needs to be engagement by the Investment Committee and the Pensions Committee (and in due course the Local Board). To this end regulation and guidance should make it a requirement that those elected Members appointed should be required to have the appropriate skills and training to be fully engaged, and also be expected to serve for a period sufficient to have an impact.

6.3 Regulation and guidance should also make it clear that a fund must develop long term investment philosophies, and develop long term strategies which are given time to mature before they are judged.

6.4 As each fund is different, and has a different liability profile keeping the asset allocation decision with those who are locally accountable is essential.

6.5 WYPF does, however, believe that part of the asset allocation decision should include determining the split between active and passive investment, as part of the liability matching exercise, and based on the local appetite for risk.

7. Q3 How many common investment vehicles should be established and which asset classes do you think should be separately represented in each of the listed asset and alternative asset common investment vehicles?

7.1 There is no simple answer to this question, and it will vary over time. The required resourcing in terms of cost, regulation and governance will have an influence, but the determining factor should be the investment objective.

7.2 It is not possible to predetermine the number of CIVs that will be required, as a CIV should only be established when absolutely necessary. Where the economies of scale or cost saving can be achieved by a simpler method that should be implemented, as each CIV will of necessity add to the financial, regulatory and governance costs of running the scheme. Collaboration will, in many instances, deliver the required scale and saving without incurring any additional costs.

7.3 As indicated earlier, there are numerous alternatives to setting up a CIV, which may achieve the objectives more cheaply and efficiently. Where this is the case it is obviously the correct choice to use the method which will deliver the greatest saving.

7.4 For active management and alternative investments there should be sufficient arrangements in place, some of which will be CIVs, that funds have adequate choice to implement their desired strategies, and that the arrangements or CIVs suffer from neither the diseconomies of scale nor manager capacity constraints.

7.5 It is entirely likely that each fund will wish to make use of more than one CIV or other joint arrangement.

8. Q4 What type of common investment vehicle do you believe would offer the most beneficial structure? What governance arrangements should be established?

8.1 In all instances the simplest and cheapest solution should be sought, beginning with collaboration. Where a CIV is needed, the type of CIV should be determined by the objectives to be achieved, rather than by an ‘off the shelf’ solution which may not be ideal.

8.2 Issues to be considered are how the governance arrangements will operate in order to maintain accountability while controlling the cost, the extent to which regulation will be required (and the cost of that, which could add considerably to the overhead), and how much professional management will be required within the CIV. It also needs to have sufficient scale to negotiate fees with the desired managers. CIVs should also consider negotiating fixed fees, as increased funds under management do not mean a directly proportional increase in costs.

8.3 The London CIV should be treated as a pilot, and the creation of further CIVs discouraged until the lessons learned from that experience can be shared.

9. Q5 In light of the evidence on the relative costs and benefits of active and passive management, including Hymans Robertson's evidence on aggregate performance, which of the options set out above offers best value for taxpayers, Scheme members and employers?

9.1 WYPF would not support the compulsory switching of all funds to passive management, as this would not actually deliver the maximum saving, as it would lose the outperformance of the successful funds.

9.2 Any compulsion should be to push funds to introduce internal management, which is identified as improving returns and reducing cost by the Hymans Robertson report, by the experience of those LGPS funds with internal management, and specifically the experience of WYPF. WYPF manages its assets on an active basis as a cost of less than 1.4bps, less than a quarter of the cost of passive management, and with lower stock turnover. The net result has been consistent outperformance over many years against the peer group, having added 50bps per annum over 20, 30 and 35 years against the local authority universe, top decile performance, before adjusting for the costs the rest of the universe pay away.

9.3 While internal management may not be practical for all funds independently, working jointly with existing internal managers or delegating to internal managers could work for all funds, and, if savings are to be maximised and improved returns are to be delivered, should be encouraged.

9.4 WYPF would not support the partial or progressive increase in passive investment, as it also fails the test of maximising the savings possible and improving returns in the same way as full compulsion.

9.5 WYPF would support the 'comply or explain' approach, something which all well governed funds should already be doing. However, restricting consideration to passive management of listed assets will restrict the potential for improved performance that could be achieved by widening the matters to be considered.

9.6 WYPF believe that the basis of compliance should not simply be a consideration of active or passive management, but a comprehensive review of investment returns for all asset classes after all costs against the chosen benchmark, and over periods that are appropriate to the asset class being considered. (Investment consultants will advise a review of an equity mandate after three years, which as economic cycles tend to be seven to ten years is clearly inappropriate).

9.7 WYPF would push the boundary further, and would suggest extending the process to require funds to explain, if they do not manage funds internally, why, as the evidence, in both the Hymans Robertson report and the WYPF experience, demonstrates this to be both cheaper and deliver improved investment returns.

9.8 As far back as the 1960s the Institute of Municipal Treasurers and Accountants, later to become the Chartered Institute of Public Finance and Accountancy, advocated 'managing the investments through the Authority's own personnel' ahead of 'the employment of a professional investment organisation'. Over time, with the advice of investment consulting firms pushing in the opposite direction, for obvious reasons, this approach, although demonstrably superior, has fallen out of fashion.

9.9 The evidence is absolutely clear, in the Hymans Robertson report and elsewhere, that internal management is both cheaper and produces superior returns. Indeed, large private sector schemes are once again establishing their own internal teams as they have seen the success of those funds which have retained their internal capacity.

9.10 WYPF would therefore support amendments to the investment regulations to enable, without convoluted use of other legislation, joint working, delegation or shared investment teams so that all funds can benefit from the lowest cost best performing method of managing their investments.

9.11 The final suggestion that funds simply be expected to consider passive management could be supported if they were given detailed guidance, and it was based on performance after all costs, but the comply or explain on that basis is more likely to generate improvements in performance.

9.12 Finally, the National Board should gather, check and distribute accurate and reliable data so that informed decisions on policy can be made, as there are risks if decisions are made on incomplete or extrapolated data.

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