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PENSION FUND COMMITTEE AND PENSION BOARD
TUESDAY, 17 DECEMBER 2019

A MEETING of the PENSION FUND COMMITTEE AND PENSION BOARD will be held in the CLEANING ACADEMY (OPPOSITE COUNCIL HEADQUARTERS) NEWTOWN ST BOSWELLS on TUESDAY, 17 DECEMBER 2019 at 10.00 AM.

ACTUARY TRAINING BY HYMANS ROBERTSON WILL COMMENCE AT 9.30 AM. MEMBERS OF THE PENSION FUND COMMITTEE AND PENSION BOARD ARE INVITED TO ATTEND.

J. J. WILKINSON,
Clerk to the Council,

10 December 2019

BUSINESS		
1.	**Apologies for Absence**	
2.	**Order of Business**	
3.	**Declarations of Interest**	
4.	**Minute** (Pages 3 - 8) Minute of Meeting held on 12 September 2019 to be noted and signed by the Chairman. (Copy attached).	2 mins
5.	**Pension Fund Investment and Performance Sub-Committee** (Pages 9 - 10) To note the Minute of the Pension Fund Investment and Performance Sub-Committee held on 30 September 2019 (Copy attached).	
6.	**Risk Register Update** (Pages 11 - 18) Consider report by Chief Financial Officer. (Copy attached).	5 mins
7.	**Business Plan Performance Update** (Pages 19 - 26) Consider report by Chief Financial Officer. (Copy attached).	10 mins
8.	**Pension Fund Budget Monitoring to 30 September 2019** (Pages 27 - 30) Consider report by Chief Financial Officer. (Copy attached).	10 mins
9.	**Information Update** (Pages 31 - 238)	5 mins

	Consider briefing paper by Chief Financial Officer. (Copy attached).	
10.	**Any Other Items Previously Circulated**	
11.	**Any Other Items which the Chairman Decides are Urgent**	
12.	**Items Likely To Be Taken In Private** Before proceeding with the private business, the following motion should be approved:- "That under Section 50A(4) of the Local Government (Scotland) Act 1973 the public be excluded from the meeting for the following items of business on the grounds that they involve the likely disclosure of exempt information as defined in paragraph 8 of Part 1 of Schedule 7A to the aforementioned Act."	
13.	**Minute** (Pages 239 - 240) Private Section of Minute of Meeting held on 12 September 2019 to be noted and signed by the Chairman. (Copy attached).	2 mins
14.	**Pension Fund Investment & Performance Sub Committee** (Pages 241 - 244) To note the Private Minute of the Pension Fund Investment and Performance Sub-Committee held on 30 September 2019 (Copy attached).	2 mins
15.	**KPMG Update** Consider verbal update.	30 mins
16.	**Quarter Performance Update** Consider report by KPMG. (To follow).	30 mins
17.	**Infrastructure Update** (Pages 245 - 250) Consider report by Chief Financial Officer. (Copy attached).	5 mins

NOTES

1. **Timings given above are only indicative and not intended to inhibit Members' discussions.**

2. **Members are reminded that, if they have a pecuniary or non-pecuniary interest in any item of business coming before the meeting, that interest should be declared prior to commencement of discussion on that item. Such declaration will be recorded in the Minute of the meeting.**

Membership of Committee:- Councillors D. Parker (Chairman), J. Brown, G. Edgar, C. Hamilton, D. Moffat, S. Mountford, S. Scott, S. Aitchison, Mr E Barclay, Mr M Drysdale, Mr M Everett, Ms K M Hughes, Ms L Ross, Ms C Stewart and Ms H Robertson

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Please direct any enquiries to Judith Turnbull Tel No. 01835 826556
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SCOTTISH BORDERS COUNCIL
PENSION FUND COMMITTEE AND PENSION BOARD

MINUTES of Meeting of the PENSION FUND COMMITTEE AND PENSION BOARD held in Council Chamber, Council Headquarters, Newtown St Boswells on Thursday, 12 September 2019 at 10.00 am

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Present:-	Councillors D. Parker (Chairman), J. Brown, C. Hamilton, D. Moffat, S. Mountford, S. Scott, Mr E Barclay, Mr M Drysdale, Mr M Everett, Ms K M Hughes, Ms L Ross, Ms C Stewart and Ms H Robertson.
Apologies:-	Councillors S Aitchison
In Attendance:-	Chief Financial Officer, Pension and Investment Manager, HR Shared Services Manager, Mr T Hodgson (KPMG), Democratic Services Officer (J Turnbull).

1. **WELCOME AND INTRODUCTION**
The Chair welcomed Ms Robertson, Borders College, and Mr Everett, Unison, new members to the Pension Board.

DECISION
NOTED

2. **MINUTE**
There had been circulated copies of the Minute of the Meeting of 13 June 2019

DECISION
NOTED for signature by the Chairman.

3. **PENSION FUND INVESTMENT AND PERFORMANCE SUB-COMMITTEE**
There had been circulated copies of the Minute of the Pension Fund Investment and Performance Sub-Committee held on 24 June 2019.

DECISION
NOTED.

4. **PENSION ADMINISTRATION SYSTEM**
There had been circulated copies of a report by Service Director HR and Communications requesting approval to delegate the responsibility for the procurement of the Pension Administration System for the Scottish Borders Council Pension Fund to the Chief Financial Officer. The report explained that Lothian Pension Fund had carried out a full tender exercise for the Pension Administration system. Scottish Borders Council Pension Fund had expressed an interest in being included, with a view to using the same terms and conditions following the outcome of the tender exercise and appointment of the preferred supplier. Aquila Heywood was the preferred bidder and our current supplier, therefore, the Fund was looking to enter into a new contractual relationship with the supplier. Costs for the procurement and implementation of the additional functionality for the Pensions Administration System would be capped at £815,601 over the following five years. Officers were continuing discussions with the supplier in an effort to reduce these costs. The system was an essential administrative tool that supported the provision of a high quality administrative service for the Pension Fund, allowing the Fund to continue to

address the complexity of legislative changes that have been added in recent years without the need to review staffing levels. The System provided an opportunity to implement a modernised application with functionality to provide an improved experience and service for members of the Pension Fund. The implementation of Members Self Service functionality would address a deliverable from the Business Plan and Communication Policy previously agreed. The additional i-Connect would streamline processing of all starters, leavers and changes, along with the removal of the annual return, which in turn would be an improved experience for employers and lead to more accurate up to date information being available for members using the Members Self Service functionality. In response to a question regarding cost and value for money, the HR Shared Services Manager, Mr Angus, advised that the Service would improve communication with all members to allow them to obtain their own pension estimates. He further advised that all other Pension Funds in Scotland were currently using the Service. The Pension and Investments Manager, Mrs Robb, added that from a governance perspective, the Service met all the necessary requirements in terms of data quality.

DECISION
AGREED the delegation of responsibility for the procurement of the contract renewed for the Aquila Heywood Pensions Administration System to the Chief Financial Officer, with costs restricted to a maximum of £815,610 over the five year term of the contract, including implementation costs for the new functionality.

5. **RISK REGISTER UPDATE**

With reference to paragraph 8 of the Minute of 13 June 2019, there had been circulated a report by the Chief Financial Officer which formed part of the risk review requirements and provided the Pension Fund Committee and Pension Board with a full register and proposed management actions to mitigate risks. Identifying and managing risk was a corner stone of effective management and was required under the Council's Risk Management Policy and process guide and CIPFA's guidance "Delivering Governance in Local Government Framework 2007". It was further reflected and enhanced in the "Local Government Pension Scheme" published by CIPFA. A full risk review had been undertaken on 15 April 2019 and the revised risk register approved by the Joint Pension Fund Committee and Pension Board on 13 June 2019. Appendix 1 to the report detailed the risks within the approved risk register which had been identified as management actions to date. The report advised that with the possible deadline for the withdrawal of the UK from membership of the EU without an agreed deal drawing close, guidance had been issued by the Pension Regulator and the Pensions and Lifetime Savings Association on the actions Pension Funds should consider to prepare for this eventuality. The Fund had reviewed these documents and paragraph 5.5 of the report, detailed the actions taken. With regard to risk 1.9, Mrs Robb advised that Hymans Robertson would be undertaking the next triannual actuarial valuation. Prior to the next meeting they would give a training session for Pension Fund Committee and Pension Board members.

DECISION

(a) **NOTED:**

(i) The management actions progressed as contained in Appendix 1, to the report;

(ii) The work undertaken in preparation for the UK potentially exiting the EU without an agreed deal; and

(iii) No new quantifiable risks have been identified since the last review; and

(b) **AGREED to a key risk review being undertaken in December 2019 and reporting of progress on the risk management actions.**

6. **SECURITIES LENDING**

There had been circulated copies of a report by Chief Financial Officer proposing that the Pension Fund undertook securities lending to enhance the future returns available from the Fund's equity investments. The report explained that securities lending was where securities were loaned on a temporary basis to a borrower for a return. Although there was an absolute transfer of title of the securities, the Fund remained the beneficial owner, with the "borrower" obligated to reimburse economic benefits during the period of the loan. Northern Trust, the Fund's custodian, had ran a securities lending programme since 1981 demonstrating long term experience in this area of activity. The programme met the required Local Government Pension Scheme regulations. Based on the current level of equity assets held by the Fund, which fell within the securities lending programme, it was estimated on a prudent basis that the Fund would gain £20k per annum additional income from participation. In response to questions, Mrs Robb advised that nine out of the 11 LGPS Funds had signed up to the security lending programme. Mr Hodgson, KPMG, clarified that securities lending was a way for the Fund to receiving additional income mitigated by indemnification risk, and would not affect the Fund's investment strategy.

DECISION
AGREED
(a) **The implementation of a securities lending programme; and**
(b) **To delegate to the Chief Financial Officer the implementation of the programme with Northern Trust.**

7. **PENSION ADMISSION POLICY**

There had been circulated copies of a report by Service Director HR and Communications proposing the adoption of the Pension Admission policy for the Scottish Borders Council Pension Fund. The report explained that the Pension Fund Business Plan, as approved at the June 2019 meeting, included the creation of a Pension Admission Policy for the Fund, to ensure the successful admission of new Admitted Bodies as required. Appendix A, to the report, contained the Pension Admission Policy, which met the legislative requirements of the Local Government Pension Scheme (Scotland). This would be referred to for any future admission requests to the Fund. Hymans Robertson, the Fund Actuary, and Pinsent Mason, external legal advisors used by the Fund, have been consulted during the preparation of this Policy on the basis that there was a significant requirement to involve them in the determination of suitability, based on risk to the Fund, to become an Admitted Body to the Fund.

DECISION
AGREED the Pension Admission Policy as set out in Appendix A to the report.

8. **SOUTH OF SCOTLAND ENTERPRISE ADMISSION REQUEST**

There had been circulated copies of a report by Service Director HR and Communications requesting approval for the admission of South of Scotland Enterprise (SOSE) into the Local Government Pension Scheme to enable access to the scheme for prospective employees of SOSE. The South of Scotland Enterprise Act 2019 was passed by the Scottish Parliament on 5 June 2019 and received Royal Assent on 12 July 2019, with Provision 12 of the Act establishing the SOSE. Scottish Borders Council Pension Fund would enter into an admission agreement, including the requirement for a Guarantee to be in place with the SOSE. No changes could be made to the status of the Fund, pension benefit for employees or employer contribution rate without the written agreement of the Pension Fund. Mr Angus confirmed that any TUPE employees would be automatically transferred to the Scottish Borders Council Pension Fund.

DECISION
AGREED to enter into an appropriate agreement with South of Scotland Enterprise to admit the body to membership of the Pension Fund on terms and conditions to the satisfaction of the Chief Financial Officer.

9. **COMMUNICATION STRATEGY REVIEW**

There had been circulated copies of a report by Service Director HR and Communications providing a review of the Communication Strategy and updating on the review of forms and communication, including annual benefit statements. In line with the Pension Fund Business Plan the Strategy should be reviewed on an annual basis. This report discharged that requirement. There were no proposed changes to the Communication Strategy, which reflected the current position of the Fund and made use of available technologies. The Pension Fund website had proven to be a useful resource and had been visited on a regular basis. This continued to be updated to reflect the current Regulations and any relevant documents or news stories were published accordingly. The Pensions Administration team had carried out a review of the supporting information provided along with the Annual Benefit Statements for this year. Work was also ongoing to review processes and associated Forms. In response to a question, Mr Angus advised that employee interest in Additional Voluntary Contributions (AVCs) had been positive; he would bring back further details to the next meeting of the Pension Fund Committee and Pension Board.

DECISION
NOTED:
(a) **That there were no changes to the Communication Strategy at this time;**
(b) **The website performance over the last 14 months; and**
(c) **That work had commenced on the review of Forms and the Annual Benefit statement documentation had been reviewed prior to issue.**

10. **PENSION FUND BUDGET MONITORING TO 30 JUNE 2019**

There had been circulated copies of a report by the Chief Financial Officer providing the Pension Fund Committee and Pension Fund Board with an update on the Pension Fund budget to 30 June 2019 including projections to 31 March 2020. The Local Government Pension Scheme (Scotland) Regulation 2014 required Administering Authorities to ensure strong governance arrangements and set out the standards they were to be measured against. To ensure the Fund met the standards a budget was approved on 7 March 2019 following the recommendations within the CIPFA accounting guideline headings. The report detailed the total expenditure to 30 June 2018 was £0.012m, with a projected total expenditure of £6.458m against a budget of £6.402m. This projected a budget variance of £56k which represented professional advisors costs and increased cost for the Pension Fund Administration IT system. In response to a question regarding investment management fees, Mrs Robb advised that fees were kept continually under review and the fees paid reflected managers' performance.

DECISION
(a) **AGREED the projected out-turn as the revised budget.**
(b) **NOTED the actual expenditure to 30 June 2019.**

11. **RESPONSIBLE INVESTMENT MONITORING**

There had been circulated copies of a report by Chief Financial Officer providing the Committee and Board with the first annual monitoring report which detailed the extent to which the Fund's Investment Managers have complied with the requirements of the agreed Statement of Responsible Investment Policy. The report explained that the Pension Fund, as part of its fiduciary duties, was required to ensure appropriate consideration was given to Environmental, Social and Governance (ESG) issues as part of its investment decisions, whilst acting in the best interest of the scheme beneficiaries. The Pension Fund approved a Responsible Investment Policy on 30 November 2018. Annual monitoring was required under the terms of the policy. All fund managers appointed since the approval of the Policy, were signatories of the United Nations Principles of Responsible Investment Code (UNPRI) and eleven out of 12 existing managers were signatories. Information had been provided by Fund Managers and scored against questions listed in paragraph 4.5 of the report, with scores for each manager shown in paragraph 4.6. Officers would work with Fund Managers who scored 15 or less to improve their performance and fully meet the objectives of the ESG policy.

Climate Action 100+ was an investor led initiative to engage greenhouse gas emitting companies to improve their emissions. The initiative had two levels of participation. It was recommended the Pension Fund signed the statement shown in paragraph 5.5 of the report to become a supporter of the initiative. This support would help demonstrate the Fund's commitment to tackling climate change and reducing carbon emissions. In response to a question regarding deforestation for the production of palm oil, Mr Robertson explained that the Fund did not invest in any companies associated with deforestation. There were examples of palm oil now being farmed on a sustainable basis without the need for de-forestation.

DECISION

(a) **NOTED the first annual performance report regarding compliance with the Pension Fund's policy on responsible investment and the scores for each of the managers.**

(b) **AGREED to become a supporter of the Climate Change 100+ initiative.**

12. **INFORMATION UPDATE**

12.1 There had been circulated copies of a briefing paper by the Chief Financial Officer providing members of the Committee and Board updates on a number of areas which were being monitored and where work was progressing. Full reports on individual actions would be tabled as decisions and actions were required.

12.2 **GMP Reconciliation**

With reference to paragraph 11.2 of the Minute of 13 June 2019, the report advised that 0.11% (22 members) remained unreconciled. These were awaiting data from HMRC or further investigation of historic payroll details. Once completed, the Committee and Board would be advised.

12.3 **Annual Benefit Statement**

In accordance with LGPS regulations, all Annual Benefit Statements had been issued prior to the 31 August 2019 deadline to active and deferred members.

12.4 **Pension Administration Strategy**

The annual review of the Pension Administration Strategy had been carried out and no changes were required.

12.5 **Scheme Advisory Board**

With reference to paragraph 11.3 of the Minute of 13 June 2019, it was noted that the Scheme Advisory Board (SAB) had not held any meetings since 24 April 2019 and the note from that meeting was still unavailable. It was noted that their next meeting was scheduled for the 30 October 2019. The SAB had agreed further analysis of fund merging and the next meeting would consider the way forward. An update would be provided at the next meeting of the Committee and Board.

12.6 **Plastics Engagement**

With reference to paragraph 11.4 of the Minute of 13 June 2019, The Fund was working with Strathclyde Pension Fund and Sustainalytics to encourage high plastic users to reduce plastic use. Apple were one of the companies proving reluctant to participate. Scottish Borders Council had agreed to support a campaign letter to Apple encouraging them to engage with the Sustainalytics.

12.7 **Training Opportunities**

With reference to paragraph 11.5 of the Minute of 13 June 2019, Baillie Gifford would hold their Training and Seminar event on 9-10 October 2019. The Local Government Chronicle were holding their annual seminar on 24-25 October. Information for both events would be emailed direct to those attending.

12.8 Future Meetings

Prior to the next meeting, on the 29 November, there would be presentation from Hymans Robertson on the triannual actuarial valuation process.

DECISION
NOTED the information update.

13. **ITEMS LIKELY TO BE TAKEN IN PRIVATE**
AGREED under Section 50A(4) of the Local Government (Scotland) Act 1973 to exclude the public from the meeting during consideration of the business contained in the following items on the ground that they involved the likely disclosure of exempt information as defined in paragraphs 6 and 8 of the part 1 of Schedule 7A to the Act.

SUMMARY OF PRIVATE BUSINESS

14. **MINUTE**
The Committee noted the Private Minute of the meeting of 13 June 2019.

15. **PENSION FUND INVESTMENT AND PERFORMANCE SUB-COMMITTEE**
The Committee noted the Private Minute of the meeting of 13 June 2019,

16. **QUARTER PERFORMANCE UPDATE**
The Committee considered a private report by KPMG.

The meeting concluded at 11.45 am

SCOTTISH BORDERS COUNCIL
PENSION FUND INVESTMENT AND PERFORMANCE SUB-COMMITTEE

MINUTES of Meeting of the PENSION FUND INVESTMENT AND PERFORMANCE SUB-COMMITTEE held in KPMG, Saltire Court, 20 Castle Street, Edinburgh on Monday, 30 September 2019 at 1.30 pm

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Present:-	Councillors D Parker (Chairman), J Brown, G Edgar, C Hamilton, D Moffat, S Mountford and Ms K M Hughes.
Apologies:-	Councillor S Scott, Ms L Ross.
In Attendance:-	Chief Financial Officer, Pension & Investments Manager, Mr D O'Hara (KPMG), Mr T Hodgson (KPMG) and Democratic Services Officer (J Turnbull).

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1. **WELCOME**
The Chairman welcomed everyone to the meeting.

2. **MINUTE**
The Committee noted the Minute of the meeting of 24 June 2019.

DECISION
NOTED for signature by the Chairman.

3. **ITEMS LIKELY TO BE TAKEN IN PRIVATE**
AGREED under Section 50A(4) of the Local Government (Scotland) Act 1973 to exclude the public from the meeting during consideration of the business contained in the following items on the grounds that they involved the likely disclosure of exempt information as defined in paragraphs 6 and 8 of part 1 of Schedule 7A to the Act.

SUMMARY OF PRIVATE BUSINESS

4. **PRIVATE MINUTE**
The Sub-Committee noted for signature the Private Minute of 24 June 2019.

5. **QUARTER PERFORMANCE UPDATE TO 30 JUNE 2019**
The Committee received a Manager Briefing Paper by KPMG.

6. **PRESENTATION - BLACKROCK UK LONG LEASE PROPERTY FUND**
The Committee noted a presentation by Blackrock UK Long Lease Property Fund.

7. **PRESENTATION - UBS**
The Committee noted a presentation by UBS.

8. **PRESENTATION - M & G INVESTMENTS**
The Committee noted a presentation by M&G Investments.

9. **URGENT BUSINESS**

Under Section 50B(4)(b) of the Local Government (Scotland) Act 1973, the Chairman was of the opinion that the item dealt with in the following paragraph should be considered at the meeting as a matter of urgency, in view of the need to keep Members informed.

10. **KPMG**

The Sub-Committee noted a verbal update from KPMG

The meeting concluded at 4.35 pm

RISK REGISTER UPDATE

Report by Chief Financial Officer

JOINT MEETING OF PENSION FUND COMMITTEE AND PENSION BOARD

29 November 2019

1 PURPOSE AND SUMMARY

1.1 **This report forms part of the risk review requirements and provides the Members of the Pension Fund Committee and Pension Board with an update of the progress of the actions taken by Management to mitigate known risks, a review of any new risks and highlights changes to any of the risks contained in the Risk Register.**

1.2 Identifying and managing risk is a corner stone of effective management and is required under the Council's Risk Management Policy and process guide and CIPFA's guidance "Delivering Governance in Local Government Framework 2007". It is further reflected and enhanced in the "Local Government Pension Scheme" published by CIPFA.

1.3 A full risk review was undertaken on 15 April 2019 and the revised Risk Register was approved by the Joint Pension Fund Committee and Pension Fund Board on 13 June 2019, with an update of the actions undertaken on 12 September 2019.

1.4 Appendix 1 details the risks within the approved risk register which have been identified management actions and the progress of these actions to date.

2 RECOMMENDATIONS

2.1 **It is recommended that the Committee and Board:**

(a) Note the management actions progress as contained in Appendix 1;

(b) Notes no new quantifiable risks have been identified since the last review; and

(c) Agrees to a key risk review being undertaken in March 2020 and reporting of progress on the risk management actions.

3 BACKGROUND

3.1 Identifying and managing risk is a corner stone of effective management and is required under the CIPFA guidance "Delivering Governance in Local Government Framework 2007". It is further reflected and enhanced in the "Local Government Pension Scheme" published by CIPFA.

3.2 The Risk Register has been developed in line with the Council's approach to risk management as set out in the "Risk Management process guide" and assesses risks using a risk score based on likelihood and impact. It has been further refined to reflect best practice "Managing Risk in the Local Government Pension Scheme" published by CIPFA.

3.3 The Pension Fund's Business Plan 2019/20 – 2021/22 was approved on 13 June 2019, setting out the aims and objectives of the Pension Fund. These aims and objectives recognised in the formation and approval of the Pension Funds risk register.

3.4 The Council's revised Risk Management process guide uses the following risk scoring:

Level of risk	Risk score
RED	High –Risk Score Range 15-25
AMBER	Medium – Risk Score Range 6 – 12
GREEN	Low – Risk Score Range 1 - 5

3.5 To comply with the Council's revised policy of risk management and best practice, a Risk Management reporting cycle was developed around the performance and business plan reporting of the Pension Fund. As a result the following cycle of reporting was adopted:

Quarterly
- Quarterly Investment Performance Report;
- Key risks, escalation of any risks that are perceived to have changed adversely and any new risks need to be considered by the Committee;
- Update on progress of risk management action delivery.

Bi-Annually
- Mid-Year Progress report on Business Plan Actions;
- Key risks, escalation of any risks that are perceived to have changed adversely and any new risks need to be considered by the Committee;
- Update on progress of risk management action delivery.

Annually
- Annual Governance Meeting with Annual Report and Policy/Strategy Performance Reports;
- Annual reporting on progress with Business Plan and approval of updated Business Plan;
- Annual reporting on progress with Risk Management Actions and approval of fully reviewed Risk Register including consideration of any new risks.

4 RISK REGISTER UPDATE

4.1 A full risk Workshop was undertaken on 15 April 2019 by Officers in order to ensure that the Risk Register's contents were still relevant and up to date. The outcome of the Workshop was then considered and approved at the Committee/Board meeting on 13 June 2019**.** The first update on the actions was reported to Committee/Board on 12 September.

4.2 The progress of the individual management actions identified in the current risk register is detailed in Appendix 1.

4.3 No new risks have been identified during the period.

4.4 A separate report on the progress of the actions within the Business plan is also contained on the agenda.

5 IMPLICATIONS

5.1 Financial

There are no direct financial implications of this report.

5.2 Risk and Mitigations

The purpose of providing the update to the Committee and Board is to improve the risk management framework for the Pension Fund, and demonstrate that the Members of the Pension Fund Committee and the Pension Board understand the risks faced, and how it is proposed to manage, mitigate or tolerate these risks. The additional proposed actions as contained in Appendix 1 are designed to directly enhance the management of risks.

5.3 Equalities

It is anticipated that there are no adverse impact due to race, disability, gender, age, sexual orientation or religion/belief arising from the proposals in this report.

5.4 Acting Sustainably

There are no direct economic, social or environmental issues with this report which would affect the Council's sustainability policy.

5.5 Carbon Management

There are no direct carbon emissions impacts as a result of this report.

5.6 Rural Proofing

It is anticipated there will be no adverse impact on the rural area from the proposals contained in this report.

5.7 Changes to Scheme of Administration or Scheme of Delegation

No Changes to the Scheme of Administration or Scheme of Delegation are required as a result of this report

6 CONSULTATION

6.1 The Monitoring Officer, the Chief Legal Officer, the Chief Officer Audit and Risk, the Service Director HR and the Clerk to the Council have been consulted and their comments have been included in the report.

Approved by

David Robertson **Signature .....**
Chief Financial Officer

Author(s)

Name	Designation and Contact Number
Kirsty Robb	Pension & Investment Manager, 01835 825249

Background Papers:
Previous Minute Reference: Pension Fund Committee and Pension Board 12 September 2019

Note – You can get this document on tape, in Braille, large print and various computer formats by contacting the address below. The Pension & Investment Team can also give information on other language translations as well as providing additional copies.

Contact us at: Pension & Investment Team, Council Headquarters, Newtown St Boswells, Melrose, TD6 OSA Tel: 01835 825249 Fax 01835 825166. email: t&cteam@scotborders.gov.uk

APPENDIX 1

Pension Fund - Full Risk Register

							Controls		Current Risk			Progress
No.	Category	Risk	Risk Factor/Cause	Effect/Consequences	Proximity	Risk Owner	Current Controls	Control Assessment	Impact	Likelihood	Score	Actions as at 29/11/19
1.1	Asset & Investment	Failure to achieve the target investment returns set out in the Statement of Investment Principles over the longer term may lead to significant increased employer contribution rates and costs of implementing changes to the investment strategy.	Inappropriate strategic asset allocation for Fund's requirements; Inappropriate investment approaches within asset class; Underperformance/ negative investment returns from investments under management; Significant and sustained market and economic events creating adverse movements in valuations; Investment Strategy inconsistent with Funding Strategy.	Significant rises in the employer contributions; Costs involved in implementing changes to investment strategy; Funding Deficit for Fund.	Ongoing	Pension Fund Committee/ Chief Financial Officer	Continual monitoring of investment performance; Engagement with Investment Adviser to update investment strategies and periodic review of strategic asset allocation; Scrutiny of Investment Manager performance by Investment & Performance Sub-Committee; Actuary reports included element of prudence. TREAT - Enhance officer role in monitoring of investment returns to enable more timely action to be taken. Encourage more thorough challenge of Advisers and Fund Managers.	Effective	4	3	12	Training requirements being actioned as part of Training plan to ensure have required skills and knowledge to enable challenge. Performance reporting information agreed with Northern Trust and KPMG.
1.4	Asset & Investment	Failure to take expert advice or risk of poor investment/actuarial advice may lead to the Fund's assets not being properly managed resulting in inappropriate investment decisions and poor returns and/or insufficient funding levels	Committee ignores advice provided by expert adviser; External adviser provides inappropriate/inaccurate/ insufficient advice to Committee/Officers.	Wrong or inappropriate decisions resulting in inadequate investment returns and/or insufficient funding levels potentially increasing employers contribution rates.	Ongoing	Pension Fund Committee/ Chief Financial Officer	Robust procurement processes around the recruitment and appointment process; Investment Adviser in place and performance reviewed annually Benchmark performance against other LAs; Regular benchmarking and cross verification of advice with other LAs through Local Govt. Pension Scheme(Scotland) Investment & Governance Group; Other info sources and discussions with non-Fund investment managers/advisers to validate advice and performance of Fund; Pension Fund Board provides scrutiny role TREAT Ongoing training for elected members of the Pension Board and Committee	Effective	4	2	8	Training requirements being actioned as part of Training plan to ensure have required skills and knowledge to enable challenge.
1.9	Asset & Investment	Investment Strategy is inconsistent with Funding Strategy may lead to the fund not being managed properly through setting employer contribution rates incorrectly resulting in the future liabilities of the Fund not being able to be covered by its assets and requiring employers to increase contribution rates to address any funding gap.	Investment Strategy for Fund set without appropriate consideration of the requirements of the Funding Strategy	future liabilities of the Fund not being able to be covered by its assets; Employers increase contribution rates to address any funding gap.	Ongoing	Pension Fund Committee/ Chief Financial Officer	Full actuarial valuation undertaken on Triennial basis. Funding Strategy Statement and Statement of Investment Principles updated and approved at the same time. As part of this assess requirement for Investment strategy to be reviewed and updated accordingly. TREAT - Undertake a full investment strategy review following 2020 valuation.	Effective	2	2	4	Work to commence November 2019 in preparation for the 2020 valuation
2.2	Employer	Adoption of either an inappropriately slow or rapid pace of funding rates for different employers may result in improper management of the Fund and result in inappropriate employer contribution rates and a possible shortfall in assets to cover the employer's liabilities.	Failure by employer to notify the fund of significant changes of membership.	Improper management of the Fund; Inappropriate employer contribution rates and a possible shortfall in assets to cover the employer's liabilities.	Ongoing	Pension Fund Committee/ Chief Financial Officer	Full actuarial valuation undertaken on Triennial basis, 2017 valuation completed; Review Pooling arrangements at each Valuation and implement appropriate de-pooling e.g. SBHA & CGI to reflect employer situations; Annual declaration made by each Employer for forth coming changes Ensure full reporting of options are presented to the Committee and Board when employer circumstances change to ensure decision making fully informed. TREAT Undertake next valuation for 2020	Effective	2	2	4	Hymans Robertson to attend November meeting in preparation for 2020 valuation. Timetable and data requirements agreed with Hymans

APPENDIX 1

Pension Fund - Full Risk Register

							Controls		Current Risk			Progress
No.	Category	Risk	Risk Factor/Cause	Effect/Consequences	Proximity	Risk Owner	Current Controls	Control Assessment	Impact	Likelihood	Score	Actions as at 29/11/19
2.3	Employer	Failure of a Scheme Employer may lead to a shortfall in the funding levels of whole Fund resulting in increases for all other employers contributions	Scheme employer ceasing to operate	Shortfall in fund as a whole with increases required in all other employers contributions	Ongoing	Pension Fund Committee/ Chief Financial Officer	Full actuarial valuation undertaken on Triennial basis; Bonds in place for Amey, and Council agreement in place for Live Borders CGI and SB Cares; Guarantee in place with SG for Visit Scotland; Contribution rates based on open/closed status of employer; Updated Admission Agreement and formal consideration of support at initial set up now implemented; Movement to closed scheme requires actuarial review, results then implemented. TREAT- Development of cessation policy.	Effective	3	2	6	Currently being developed will be presented to Committee 5th March 2020
3.2	Resources & skills	Failure to provide appropriate training and support and/or secure Board/Committee Member engagement in Training Programme may lead to ineffective management of the Fund as a result of poorly informed decision making.	Availability of members to attend training; Inappropriate training programme.	Ineffective management of the Fund as a result of poorly informed decision making.	Ongoing	Pension Fund Committee/ Chief Financial Officer	Approved Training Policy; Training assessment informs the annual training plan; Training opportunities are made available to members of Board and Committee; Members have access to External Adviser and Council Officers to help advise and inform them in relation to decisions taken by the Committees; Access to the Pension Regulator's website; Participation in training is published in Annual Report. All new members required to complete Trustee Toolkit within 6 months of joining Committee or Board TREAT - annual monitoring and reporting undertaken	Effective	3	3	9	Annual review completed and findings reported 13 June 2019. Annual training plan approved 13 June 2019 to address required training areas. 13 Members met minimum training requirement as at end October
3.5	Resources & skills	Failure of Officers to maintain sufficient level of competence to discharge their duties could lead to failure to manage the Fund effectively as a result of their inability to provide appropriate decision making support and advice.	Changes in legislation; New investment types and vehicles; Lack of documented procedures.	Failure to manage the Fund effectively.	Ongoing	Chief Financial Officer/ Service Director of HR	Use of External Advisers provides additional resilience and resources; Competency appraisal process implemented to identified training and development requirements; Active participation in Scottish Investments and Governance Group (IGG) and Scottish Pensions Liaison Group; Procedural notes completed Regular engagement with external Investment Managers to supplement knowledge. TREAT - Improvement in quality of procedure notes for officers. Implementation of Competency Framework for all staff	Partially Effective	2	3	6	Procedural notes being implemented for Business World processes. Wider process reviews are being processed by Admin. Competency Framework to be implemented for all staff upon official launch of Framework and appraisal process
4.5	Liquidity	New pension access reforms ("freedom of choice") may lead to pension fund members electing to transfer all or part of their pension entitlement much earlier than projected resulting in the potential for a significant change in the liability profile for the Fund.	Changes in legislation and increase in awareness.	Requirement to release large amounts of cash to members; Disinvest current assets in a much more unplanned manner with the potential to disadvantage the Funding position; Scheme sanction charges for any transfer to unapproved scheme.	Ongoing	Chief Financial Officer/ Service Director of HR	Requests for transfers are currently mitigated by obtaining enhanced levels of indemnity for the members, the receiving scheme and written confirmation of the scheme approval from HMRC; Monitoring will be undertaken during the year and reported to Members as part of the annual report. With effect from 1 April 2015 members with funds in excess of £30k must receive professional advice from a Financial Conduct (FCA) regulated adviser, includes signed declaration by individual; Continue to monitor ongoing legislation around this area. Communication Strategy agreed and website launched TREAT - Review and watch to be placed on advice and guidance issued from The Pension Regulator and Government.	Effective	2	2	4	Continue to monitor advice and information from The Pension Regulator and Government bodies.

APPENDIX 1

Pension Fund - Full Risk Register

							Controls		Current Risk			Progress
No.	Category	Risk	Risk Factor/Cause	Effect/Consequences	Proximity	Risk Owner	Current Controls	Control Assessment	Impact	Likelihood	Score	Actions as at 29/11/19
5.3	Administrative	Failure to provide pensions administration service due to major operational disruption could lead to inability to provide a high quality pension service to members	Loss of main office; Computer system; Staff absence.	Ability to process payments on time; Financial distress to members; Reputational risk.	Ongoing	HR Shared Services Manager	Robust business continuity processes in place across the Council around key business processes, including a disaster recovery IT site. Reviewed regularly. Pensions Administration System is hosted system, along with Windows 7 provides improved ability for homeworking; TREAT - in line with core HR risk review full business continuity review to be undertaken.	Effective	2	3	6	Work to commence on business continuity review
5.4	Administrative	Failure to prevent fraud or misappropriation by scheme member, employee or scheme employer within the Fund may lead to loss of funds.	Lack of monitoring; Lack of segregation of duties.	Inability to provide a high quality pension service to members; Financial loss to the Fund; Impact on benefits paid to members.	Ongoing	HR Shared Services Manager	Robust segregation of duties and other internal controls to mitigate against this risk; Immediate action taken upon discovery of fraud; Internal & External Audit programme also picks up the monitoring of this risk. TREAT - to request from each External Employers audited accounts to provide assurance on their internal controls	Effective	2	2	4	Annual assurance review requests scheduled to be issued November 2019.
6.1	Regulatory & Compliance	Failure to administer and manage Fund in line with requirements of legislation and other regulations e.g. LGPS regulations, HMRC may lead to benefits calculated incorrectly and/or breach legislation	Changes to legislation; Lack of staff training; Lack of knowledge and skills	Wrong pension payments made or estimates given; Breach of regulations; Prosecution.	Ongoing	HR Shared Services Manager/ Capital & Investments Manager	Compliance with new accounting standards and pension fund regulations are subject to robust internal and external audit review and reporting; Participation in the active Scottish Pensions networks and CIPFA updates; External Audit review extends beyond financial controls; Pension Board review of decisions; PRD process implemented to identify training and development requirements. TREAT - Implementation of Competency Framework to all staff	Effective	2	2	4	Competency Framework to be implemented for all staff upon official launch of Framework and appraisal process
6.2	Regulatory & Compliance	Changes in legislation and other regulatory frameworks may impact adversely on the Fund in terms of funding levels and governance structures	Central Govt. legislation changes.	Loss of independence in the management of the Fund; Impact on Fund value and benefits; Increased costs to the Fund, employer contributions; Potential loss of active scheme members.	Ongoing	Chief Financial Officer/ Service Director of HR	Participation in active CIPFA and Scottish Pension network allow changes and impacts to be identified quickly; Involvement with COSLA discussions on Pensions; Monitoring and highlighting actions and decisions from scheme advisory board; TREAT Seek to input into any of the legislative change through active membership of COSLA & active engagement with the Scheme Advisory Board	Partially Effective	4	4	16	Responding to all consultations and participating in all national groups. Chief Financial Officer active member of Director of Finance group. Monitoring Scheme Advisory Board web site on monthly basis
6.3	Regulatory & Compliance	Failure to produce accounts, notices and publications correctly or on time resulting in inability to manage the fund effectively and compliantly.	Lack of capacity; Conflicting operational demands, including Transformational activity.	Accounts qualified by External Auditors; Referral to Pensions Regulator or Scheme Advisory Board	Ongoing	Corporate Finance Manager	Compliance subject to robust internal and external audit review and reporting; Participation in the active Scottish Pensions networks; Staff training requirements identified via PRD and attendance at appropriate training events. TREAT - Implementation of Competency Framework to all staff	Effective	2	2	4	Competency Framework to be implemented for all staff upon official launch of Framework and appraisal process
6.5	Regulatory & Compliance	Changes in LGPS Structures	Review by Scheme Advisory Board on LGPS structures	Fund may cease to exist, assets may be pooled, Administration could pooled	Ongoing	Chief Financial Officer	Monitoring of political position via Scheme Advisory Board TREAT - Actively engage with Scheme Advisory Board and consultants undertaking review	Partially Effective	3	4	12	Minutes of SAB tabled as meetings for information when available
7.3	Reputation	Failure to appoint relevant advisers and review their performance may lead to inappropriate management of the Fund resulting from poor advice to decision makers	Lack of capacity of Officers to monitor.	Failure to achieve Pension Fund objectives; Inappropriate management of the Fund resulting from poor advice to decision makers; Legal challenge	Ongoing	Chief Financial Officer/ Service Director of HR	Identify requirements of external advisers and appoint appropriately. Annual review undertaken with Investment Advisor and Custodian. TREAT - Implement annual review of Advisers;	Effective	2	2	4	Review meetings scheduled for Oct 2019

APPENDIX 1

Pension Fund - Full Risk Register

							Controls		Current Risk			Progress
No.	Category	Risk	Risk Factor/Cause	Effect/Consequences	Proximity	Risk Owner	Current Controls	Control Assessment	Impact	Likelihood	Score	Actions as at 29/11/19
7.6	Reputation	Pension Fund does not fulfil its fiduciary duties with appropriate regard with its ESG responsibilities	Lack of skills & knowledge Lack of information from Managers Lack of clear policy	Failure to manage the Pension Fund properly; Financial loss; Reputation damage.	Ongoing	Chief Financial Officer	Training provided to Members and Officers on their roles and fiduciary responsibility; Monitoring on quarterly basis of Segregated Portfolios voting Policy contained with Statement of Investment Principles including support for UNPRI. Responsible Investment policy approved TREAT- monitoring arrangements to be implemented	Partially Effective	2	2	4	First annual monitoring report presented to Committee/Board 12 Sept 2019

BUSINESS PLAN PERFORMANCE UPDATE

Report by Chief Financial Officer

JOINT MEETING OF PENSION FUND COMMITTEE AND PENSION FUND BOARD

17 December 2019

1 PURPOSE AND SUMMARY

1.1 **This report is to provide members of the Committee and the Board with an update on delivery of the actions within the approved Business Plan.**

1.2 The 2019/20 – 2021/22 Business Plan for the Pension Fund was approved by the Committee/Board on 13 June 2019. Included within the plan were key objectives and actions with target dates.

1.3 As part of the risk register update approved at Committee/Board on 12 September 2019 it was agreed a mid-year progress report on the business plan actions would be presented to Members at the December 2019 meeting and a further progress report and update at the June 2020 meeting.

1.4 There are 19 key tasks due for completion during 2019/20. Of these 11 are fully complete, 4 are on track to be completed by the approved target date and 4 require revised target dates as detailed below.

2 RECOMMENDATIONS

2.1 **It is recommend that the Pension Fund Committee and Pension Board:-**

(a) Notes the progress of the 2019/20 actions within the business plan

(b) Agrees a revised target date of 31 March 2020 for completion action P2-A1- review of current taxation position

(c) Agrees a revised target date of 31 March 2020 for completion of action P4-A1 – develop and gain approval of Cessation and Discretion Policy

(d) Agrees a revised target date of 31 March 2020 for completion of action P6-A1 – complete full reconciliation of Guaranteed Minimum Pension between Fund & HMRC

(e) Agrees a revised target date of 31 December 2019 for completion of action P6-A2 – creation of rectification plan measuring of Common & specific data following annual review & return to The Pension Regulator

(f) Agrees a further update be presented at the June 2020 meeting

3 BACKGROUND

3.1 Local Government Pension Scheme (LGPS) administering authorities are required to prepare, publish and maintain statements of compliance against a set of six principles for pension fund investment, scheme governance, discloser and consultation. These are referred to as the "Myners Principles" and the reporting on compliance, as required by the LGPS Regulations, must be included in the Statement of Investment Principles.

3.2 Best practice indicates that having a business plan for the Pension Fund is a good way of demonstrating compliance with the "Myners Principle" that underpin effective decision making. The Pension Fund Committee and Board approved the 2019/20 – 2021/22 business plan on 13 June 2019.

3.3 As part of the risk register update approved by Committee/Board on 12 September 2019 it was agreed a progress report on the actions contained within the business plan would be reported to the Committee and Board at the December 2019 meeting.

4 ACTION PLAN

4.1 The action plan details how the achievement of the objectives will be measured. Appendix 1 shows the actions to be completed in 2019/20 and provides an update on each individual measure.

4.2 There are 19 key tasks due for completion during 2019/20. Of these 11 are fully complete, 4 are on track to be completed by the approved target date and 4 require revised target dates as detailed below.

4.3 The action to undertake a review of the current taxation position of the Fund was due to be completed by 31 December 2019 however due to workload information was only provided to KPMG in October. The review is now underway and a full report of the findings of the review will be presented on 5 March 2020.

4.4 The action to develop and approve a Cessation and Discretion Policy will not be completed by 31 December 2019 due to staff resource constraints. The report will be presented at the meeting on 5 March 2020.

4.5 The full reconciliation of Guaranteed Minimum Pension (GMP) amounts between the Fund and HMRC had a target date of 31 December 2019, we have been advised that final files are not due to be issued by HMRC until December 2019 so it is highly unlikely that this will be completed by the anticipated date. Once the files have been received a new completion date will be activated.

4.6 The rectification plan has been created for Measuring the Common and Specific data, the majority of changes have been applied to the Pensions Admin System, however, due to staff resource constraints not all have been actioned. A further report will be run from which a further rectification plan will be created and actioned.

5 IMPLICATIONS

5.1 Financial

There are no financial implications to this report.

5.2 **Risk and Mitigations**

The monitoring of the delivery of actions within the Business Plan including identification of responsible officer and timescales, as set out in this report, is part of the governance framework to manage the operation of the Pension Fund and ensure effective decision making. Some of the actions are designed to directly enhance the management of risks.

5.3 **Equalities**

No equalities issues have been identified for the measures currently undertaken with the Business Plan. If any future measures identifies where there is a potential for the requirement for an Equalities Impact Assessment, this will be undertaken at the time of undertaking the work proposed in the Plan.

5.4 **Acting Sustainably**

There are no direct economic, social or environmental issues with this reports which would affect the Council's sustainability.

5.5 **Carbon Management**

There are no direct carbon emissions impacts as a result of this report.

5.6 **Rural Proofing**

It is anticipated there will be no adverse impact on the rural area from the proposals contained in this report.

5.7 **Changes to Scheme of Administration or Scheme of Delegation**

No changes are required as a result of this report.

6 CONSULTATION

6.1 The Monitoring Officer, the Chief Legal Officer, the Chief Officer Audit and Risk, the Service Director HR, the Clerk to the Council and Corporate Communications have been consulted on the report and their comments have been incorporated.

Approved by

David Robertson
Chief Financial Officer **Signature .....**

Author(s)

Name	Designation and Contact Number
Kirsty Robb	Pensions and Investment Manager, 01835 825249

Background Papers: Pension Fund Business Plan 2019/20 – 2021/22
Previous Minute Reference: Joint meeting Pension Fund Committee and Pension Fund Board, 13 June 19

Note – You can get this document on tape, in Braille, large print and various computer formats by contacting the address below. The Pensions & Investment Team can also give information on other language translations as well as providing additional copies.

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email: t&cteam@scotborders .gov.uk

What we want to achieve … (Objective)
Set levels of employer contribution that will build up a fund of assets that will be sufficient to meet all future benefit payments from the Fund, and invest in assets that grows the Fund's assets in a such a way that produces levels of employer contribution that are as stable as possible

How?					By whom?		
Action No.		How we will achieve our objective … (Action)	Key Tasks	PI ref.	Owner	Target	Progress
P	1	**Review Pension Strategies informed by 2017 and 2020 Triennial Valuation Results**					
		Monitor and report investment performance	Monitor and report investment performance	P1-A1	P&I Manager	Ongoing	Reports produce quarterly to Joint Committee and Board. Performance and Sub Committee.
		Undertake and complete Triennial valuation	Data provision review to meet the requirements of newly appointed actuary	P1-B2	HRSS Manager	31/3/20	In progress
		Approval and implementation of 2020 Triennial Valuation employer contribution results, including update of Funding Strategy Statement	Correct employer contribution rates in Pensions System for each employer	P1-C1	HRSS Manager	30/6/19	Actioned within pension admin system
			Pension Fund Committee approval of Funding Strategy Statement	P1-C2	P&I Manager	30/6/19	Report presented to Committee on 13/06/19
P	2	**Maximise investment performance**					
		Ensure Fund reclaims all tax possible	Undertake review of current taxation position	P2-A1	P&I Manager	31/12/19	KPMG currently undertaking review
		Review opportunities to ensure assets working to maximum, whilst ensuring assets secure	Review stock lending opportunities	P2-B1	P&I Manager	31/12/19	Report agreed at Joint meeting on 12/09/19

What we want to achieve … (Objective)
Deliver a High Quality Pension Service to Members

How?					By whom?		
Action No.		How we will achieve our objective … (Action)	Key Tasks	PI ref.	Owner	Target Date	Progress
P	**3**	**Develop and Implement an effective Communication Strategy for the Pension Fund**					
		Review Communication Strategy and Action Plan in line with best practice and technological advancements	Review of Communications strategy and action plan	P3-A1	HRSS Manager	30/9/19	Report presented to Committee on 12/09/19
		Continue to proactively manage and engage Pension Fund Employers	Hold Annual Employer Liaison Meeting	P3-A2	HRSS Manager	31/3/20	Meeting to be arranged for February 2020
		Review all forms and communication material, including annual benefit statements	Review all forms and communication material, including annual benefit statements	P3-A3	HRSS Manager	30/9/19	Report presented to Committee on 12/09/19
P	**4**	**Rev Development of Cessation and Discretion Policy**					
		Develop and gain approval of Cessation and Discretion Policy	Develop and gain approval of Cessation and Discretion Policy	P4-A1	HRSS Manager/P&I Manager	31/12/19	Work progressing to be presented to Committee 05/03/20
P	**5**	**Ensure successful admission of new Admitted Bodies as required**					
		Develop formal policy for Admitted Bodies	Develop formal policy for Admitted Bodies	P5-A1	HRSS Manager	31/12/19	Policy approved on 12/06/19

Action No.		How we will achieve our objective … (Action)	Key Tasks	PI ref.	Owner	Target Date	Progress
P	**6**	**Ensure accuracy of Pension Records**					
		Undertake full reconciliation of Guaranteed Minimum Pension (GMP) amounts between Fund and HMRC	Complete full reconciliation of Guaranteed Minimum Pension between Fund & HMRC	P6-A1	HRSS Manager	31/12/19	Unlikely to meet target date as file from HMRC not due until December 2019
			Creation of rectification plan measuring of Common and Specific Data following annual review and return to The Pension Regulator.	P6-A2		30/9/19	Main changes have been actioned, further report due to be run in coming weeks from which a further rectification plan will be developed
P	**7**	**Implementation of self service facility**					
P		Progress contract renewal of Pensions Admin system	Progress contract renewal of Pensions Admin system	P7-A1	HRSS Manager	30/9/19	Report presented to Committee on 12/09/19

What we want to achieve … (Objective)
Ensure that Scottish Borders Pension Fund is managed effectively, transparently and compliantly

How?					By whom?		
Action No.		**How we will achieve our objective … (Action)**	**Key Tasks**	**PI ref.**	**Owner**	**Target Date**	**Progress**
P	**8**	**Continue to develop robust governance and risk management**					
		Review and update Governance Policy and Compliance Statement	Review and update Governance Policy and Compliance Statement	P8-A1	P & I Manager	30/6/19	Approved at Committee on 13/06/19
		Develop and deliver 2019/20 Training Programme	Pension Fund Committee approval of Training Policy 2018 and Training Programme 2019/20	P8-A2	P & I Manager	30/6/19	Training plan approved by Committee 13/06/19, delivery in progress
			Training Needs Self-Assessment Levels from 2018/19 to 2019/20	P8-A4			
		Review and update Pensions Administration Strategy	Pension Fund Committee approval of Pensions Administration Strategy	P8-A3	HRSS Manager	30/9/19	No Changes required as reported at Committee on 12/09/19
P	**9**	**Review services provided externally to ensure that these represent best value to the Fund**					
		Develop and implement an annual assessment cycle of Investment Adviser and Officer support to the Pension Fund Committee and Pension Fund Board	Undertake annual assessment of Investment Adviser and Officer Support to Committee and Board	P9-A1	P & I Manager	31/3/20	Progressing, on target

PENSION FUND BUDGET MONITORING TO 30 SEPTEMBER 2019

Report by Chief Financial Officer

JOINT MEETING OF PENSION FUND COMMITTEE AND PENSION FUND BOARD

17 December 2019

1 PURPOSE AND SUMMARY

1.1 **The purpose of this report is to provide the Pension Fund Committee and Pension Fund Board with an update position of the Pension Fund budget to 30 September 2019 including projections to 31 March 2020.**

1.2 The Local Government Pension Scheme (Scotland) Regulation 2014 requires Administering Authorities to ensure strong governance arrangements and sets out the standards they are to be measured against.

1.3 To ensure the Fund meets the standards a budget was approved on 7 March 2019 following the recommended structure within the CIPFA accounting guidelines headings. This report is the second quarterly monitoring report of the approved budgets.

1.4 The total expenditure to 30 September 2019 is £0.067m with a projected total expenditure of £6.458m against a budget of £6.458m. There is no projected variance.

2 RECOMMENDATIONS

2.1 **It is recommended that the Pension Fund Committee notes the actual expenditure to 30 September 2019 and the projected budget outturn to 31 March 2020.**

3 BACKGROUND

3.1 The Local Government Pension Scheme (Scotland) Regulation 2014 requires Administering Authorities to ensure strong governance arrangements and sets out the standards they are to be measured against. The Fund is required to report on an annual basis within its Annual Report if it has met these standards. To demonstrate full compliance requires the setting and monitoring of a budget for the Fund.

3.2 A budget was approved at the Joint Pension Fund Committee and Pension Fund Board meeting on 7 March 2019 for 2019/20. The approved budget follows the Local Government Pension Scheme management costs guidance issued by CIPFA into the following 3 categories.

Category	**Costs included**
Investment Management	All expenses incurred in relation to management of pension fund assets. Including costs invoiced direct and fees deducted from fund assets. Custody and performance fees also included
Administration	Costs incurred in administration of the fund including staff, IT costs and associated overheads, benefits consultants.
Oversight and governance	Costs incurred in the selection & appointment of managers, audit fees, investment advisory services, tax advisory, accounting services, banking service and support to the pensions committee and board.

4 MONITORING TO 30 SEPTEMBER 2019

4.1 The table below shows the expenditure to 30 September 2019, projected out-turn to 31 March, full year budget

	Expenditure to 30 Sept 19 £000's	Projected to 31 March 20 £000's	2019/20 Budget £000's	2019/20 Variance £000's
Investment Management	370	5,750	5,750	0
Administration	241	446	446	0
Oversight & Governance	56	262	262	0
Total	**667**	**6,458**	**6,458**	**0**

4.2 All budget lines are currently projected within budget. The investment management fees however are fully dependant on the value of the assets. If asset values increase or decrease over the remaining year fees move accordingly.

4.3 Investment Management fees are charged on a quarterly basis in arrears based on the value of assets held. The second quarter investment management fees are not therefore included in the expenditure to 30 September 2019 totals.

4.4 Following the launch of the Cost Transparency Initiatives (CTI) templates all Managers were requested to signing up and would be able to complete the templates on a quarterly basis. The CTI timescales allows managers to April 2020 to fully comply with the templates. Most fund managers have indicated they are currently working on their systems to allow the templates to be completed quarterly but for 2019/20 will only be able to produce one annual return in April 2020. Two Fund managers have however returned completed templates for the first two quarters.

4.5 The invoices for the Custodian accrued for the final quarter of 2018/19 were unpaid at 30 June 2019 due to a delay in the invoicing at Northern Trust. This has resulted in the credit expenditure figure under "oversight & governance."

5 IMPLICATIONS

5.1 Financial

There are no costs attached to any of the recommendations contained in this report.

5.2 Risk and Mitigations

This report is part of the governance framework to manage the operation of the Pension Fund and reflects the compliance with the best practice recommendations. Risks are managed in line with the Corporate Risk Management framework, with risks and controls monitored and reported on a quarterly basis.

5.3 Equalities

It is anticipated that there are no adverse impact due to race, disability, gender, age, sexual orientation or religion/belief arising from the proposals in this report.

5.4 Acting Sustainably

There are no direct economic, social or environmental issues with this report which would affect the Council's sustainability policy.

5.5 Carbon Management

There are no direct carbon emissions impacts as a result of this report.

5.6 Rural Proofing

It is anticipated there will be no adverse impact on the rural area from the proposals contained in this report.

5.7 Changes to Scheme of Administration or Scheme of Delegation

There are no changes to the Scheme of Administration or the Scheme of Delegation required as a result of this report.

6 CONSULTATION

6.1 The Monitoring Officer, the Chief Legal Officer, the Chief Officer Audit and Risk, the Service Director HR, the Clerk to the Council and Corporate Communications have been consulted and any comments received have been incorporated into the final report.

Approved by

David Robertson
Chief Financial Officer **Signature .....**

Author(s)

Name	Designation and Contact Number
Kirsty Robb	Pension & Investment Manager, 01835 825249

Background Papers:
Previous Minute Reference: Joint Pension Fund Committee and Pension Fund Board 12 Sept 2019

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INFORMATION UPDATE

Briefing Paper by Chief Financial Officer

PENSION FUND COMMITTEE & PENSION BOARD

29 November 2019

1 PURPOSE AND SUMMARY

1.1 **This briefing paper is to provide members of the Committee and the Board with an update on a number of areas which are being monitored and areas where work is progressing. Full reports on the individual areas will be tabled as decisions and actions are required.**

2 GMP RECONCILATON

2.1 There is no further update available at this stage as we are still waiting on the final report from HM Revenue and Customs.

3 AVC UPDATE

3.1 In June 2019 Scottish Borders Council, SB Cares and Live Borders implemented a Shared Cost AVC Scheme whereby employees are able to benefit from a reduction in National Insurance contributions in addition to saving Income Tax when compared to a traditional AVC. There are scheme rules that must be complied with before an employee can be accepted to the scheme, these include the post sacrifice hourly rate being above the National Minimum Wage rate and the National Insurance threshold, the second ensuring there is no negative impact on other benefits an employee may accrue.

3.2 Within Scottish Borders Council and SB Cares there has been an increase of 23 employees participating in the AVC scheme taking the number contributing up to 68, the breakdown between the two schemes is as follows: -

	No of Employees
Shared Cost AVC Scheme	58
Traditional AVC Scheme	10
Total	68

4 SBCARES REINTERGRATION WITH SCOTTISH BORDERS COUNCIL

4.1 As agreed at a meeting of Scottish Borders Council all employees of SB Cares will be transferred to Scottish Borders Council with effect from 1 December 2019. As a result of this there are a number of administrative tasks that need to be carried out in relation to the Local Government Pension Scheme. This includes the updating of the Pensions Administration System to reflect the change in Employer and the processing of an interim annual return to collect the pension information related to the first eight months' employment.

We will also be required to update all our policy documents to reflect the change in status of SB Cares from being an active to closed admitted body. This will be done at the point of reviewing the specific policy document in accordance with the Business Plan.

5 SCHEME ADVISORY BOARD

5.1 The Scheme Advisory Board has released the findings report from the consultation on the future structure of LGPS in Scotland. The report is attached for information.

5.2 The Scheme Advisory Board held a meeting on 30th October. Agenda items were as follows

- GAD presentation on Section 13 Report
- Structure Review – Scoping
- Transparency On-line Data Portal
- Member Training
- SAB Work Plan
- SPPA update including Court of Appeal judgement

5.3 The summary note from the meeting of 24th April is still not available.

6 McCloud Update

6.1 In December 2018 the Court of Appeal ruled the transitional provisions introduced in 2015 for the Judicial and Firefighters pension schemes gave rise to unlawful discrimination. The matter was referred to the Employment tribunals to determine a remedy for claimants.

6.2 Subsequently the Chief Secretary to the Treasury made a written ministerial statement confirming that all main public service schemes would need to be reviewed in relation to the transitional protection and this may have an effect on LGPS. This may have an impact on the 2020 valuation process and the liabilities of the fund. The attached update has been provided by SPPA and further updates will follow as required.

7 AUTOENROLEMENT

7.1 Scottish Borders Council have carried out the re-enrolment of employees in accordance with The Pension Regulators guidance, with re-enrolment taking place from 1 October 2019

7.2 In terms of the Local Government Pension Scheme there were 55 employees re-enrolled due to meeting the Eligible Job Holder criteria and a further 8 employees were returned to the main scheme from the 50/50 option.

7.3 To date Opt Outs have been received for 23 of the 55 employees who were re-enrolled, resulting in 58% of those enrolled remaining in the scheme.

8 TRAINING OPPORTUNTIES

8.1 The PSLA Investment conference will be on from afternoon of 11 March to 13 March 2020 at the EICC in Edinburgh. The programme is not yet available but will be circulated as soon as it's received. The event is over 3 days but anyone wishing to attend do not to attend all 3 days. The event is free however any place cancelled after 28 February or if non-attendance once booked, will incur a charge of £370.

9 FUTURE MEETINGS

9.1 The dates of future meetings are given below for information

5th March 2020

11th June 2020

Author(s)

Name	Designation and Contact Number
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STAKEHOLDER UPDATE ON EMPLOYMENT TRIBUNAL CONSIDERATION OF PUBLIC SERVICE PENSION SCHEME TRANSITIONAL PROTECTION CASES

- On 20 December 2018, the Court of Appeal in Lord Chancellor v McCloud (and others) held that in relation to the judicial and firefighters' pension schemes, transitional provisions introduced in 2015 gave rise to unlawful age discrimination. The matter has been referred to Employment Tribunals to determine a remedy for claimants.

- Respondent departments and employers are engaging with the Employment Tribunals and claimants to reach agreement on the steps that will be taken to remedy the discrimination identified by the Courts.

- On 15 July 2019 the Chief Secretary to the Treasury made a written ministerial statement (HCWS1725) confirming that, as 'transitional protection' was offered to members of all the main public service pension schemes, the government believes that the difference in treatment will need to be remedied across all those schemes. The statement set out that government, alongside Employment Tribunal discussions, will also engage with employer and member representatives, and the devolved administrations, to help inform proposals to the Tribunal and in respect of the other public service pension schemes.

- The purpose of this note is to set out the outcome of initial Case Management Discussions in the Employment Tribunals and to confirm next steps.

- Case management discussions (CMDs) have been held in respect of the judiciary, police and Ministry of Defence police. Further CMDs will shortly be taking place in relation to claims made by firefighters and NHS employees. A CMD for firefighters is scheduled for the 18 December 2019. Others will be scheduled in due course.

- The discrimination that has been identified in the public service schemes arises between the different treatment between members in these categories:

    - those individuals who were members of pre-2015 public service schemes as at 31 March 2012 and were fully transitionally protected by remaining in that scheme after 1 April 2015 (as a result of being 10 years within their normal pension age); and
    - those who were members of the pre-2015 schemes as at 31 March 2012 and were not treated as fully transitionally protected and moved to new post-2015 arrangements on or after 1 April 2015).

- The relevant Employment Tribunal will oversee the process of agreeing a remedy for claimants. The government has previously confirmed that the discrimination will also need to be removed for all other members of public service pension schemes who have relevant service.

- The local government pension scheme in England and Wales contains different transitional provisions and will be considered separately by MHCLG.

- The government has agreed an interim declaration with claimants in the case management discussions for the judicial, police and MoD police claimants. The declarations mean that the

claimants are entitled to be treated as members of the appropriate pre-2015 schemes. The government intends to extend the same treatment to all members of the public service pension schemes (whether claimants or not) who are in the same legal and factual position as the claimants.

- However, this is not straightforward as simply returning all relevant members to the pre-2015 schemes would cause detriment for some members of public service pension schemes as there are hundreds of thousands of individuals who were in post as at the 31 March 2012 that are expected to be better off in the new schemes.

- Changes to legislation will be necessary to deliver the commitment to remove the discrimination from all public service pension schemes whilst ensuring that members can instead keep the benefits that they have earned to date.

- Any changes to the schemes will be subject to consultation with stakeholders to ensure that any issues are properly understood and addressed alongside the remedy agreed by the Employment Tribunal for individual claimants.

- Further details on proposed changes and the process for consultation will be confirmed shortly.

Report on the Consultation on the

Review of the Structure of the Scottish Local Government Pension Fund

Part 1: Conclusions and key issues

Carried out by the Pensions Institute

on behalf of the Scottish Local Government Pension Scheme Advisory Board

David Blake

Matthew Roy

April 2019

Contents

About the Scheme Advisory Board

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

About the Pensions Institute

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

David Blake

Professor David Blake is the Director of the Pensions Institute and Professor of Pensions Economics at Cass Business School. He was educated at the London School of Economics, gaining a PhD in Financial Economics in 1986. David previously worked at the LSE, the London Business School and Birkbeck College before joining Cass Business School (part of City, University of London) in 2004 as a professor in the Finance Faculty. He set up the Pensions Institute in 1996.

Matthew Roy

A Fellow of the Pensions Institute, Matthew has worked in finance, policy and strategy roles in Europe and Asia Pacific. Matthew is New Zealander by birth, holding an M.Comm (1st Class Hons.) from the University of Canterbury. Beginning his career as a policy adviser he has worked in economics, securities marketing and as a journalist to international finance publications. Since moving to Scotland in 2011, he has advised global financial organisations on marketing strategy and participated in third-sector community energy projects and regeneration bodies.

Executive summary and conclusions

The 2018 consultation carried out into the structure of the Scottish Local Government Pension Scheme (SLGPS) by the Scheme Advisory Board (SAB) suggests the current scheme has a number of flaws and raises sufficient evidence that the Scottish Government should evaluate the case for mergers between funds in the scheme.

Fifty six respondents provided views in 49 responses to the consultation. The exercise was open to all constituents of the scheme,[1] and presented four options for the future structure of SLGPS: retain the current structure with 11 funds; promote cooperation; pool investments between funds or merge the funds into one or more new funds.

Respondents provided a diversity of views and actionable intelligence, which suggests that despite some limitations on the scope of this exercise,[2] the consultation can be used to inform the future structure of the SLGPS. To evaluate these views, the analysis that follows is based on qualitative assessments of the arguments made by respondents rather than the quantity of respondents making a particular argument.

Although the analysis in this report is largely to present consultees' views, the Pensions Institute provides some additional considerations on how the objectives of the scheme could guide the choices about structure; and offers views on some key issues where respondents differed on their interpretation of facts. The summary concludes with what seem to be the most pressing actions.

Views on the options

Respondents were asked to evaluate the scheme against the criteria of investment costs, governance, operating risks and ability to invest in infrastructure. Their responses show two divergent views of the current structure and its future options based both on these criteria and other factors introduced by respondents.

Thirty six respondents including nine administering authorities say they prefer the status quo or cooperation options. Although cooperation was presented as a separate option, it is shown by the consultation to be a variant of the status quo. The views of these respondents are based on a positive evaluation of the scheme against the consultation criteria. They also say the settings of the scheme such as funding and contribution rates show it is a success; the scheme is insufficiently flawed to justify the risks of structural change; and the case has not been made for other options.

Seventeen respondents, including two administering authorities, two unions, five multi-fund employers and representatives of admitted bodies say the system is not optimal when measured against the criteria, has significant flaws and should be abandoned in favour of pooling or merger. Pooling or merger would lead to benefits on the consultation criteria – an estimate in one response suggested cumulative gains of £1bn after 10 years[3] – give all scheme members access to the benefits of scale and remove the disadvantages of the scheme's administering authority based, regional structure.

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[1] Members, employers, representative groups and organisations which administer the scheme – pension boards, committees and administering authorities.

[2] Employee representative groups were encouraged to respond on behalf of scheme employee members. The consultation relied on administering authorities and councils to invite the participation of employers and admitted bodies.

[3] Joint submission by the Lothian Pension Fund executive, Lothian Pensions Board and Pensions Committee of City of Edinburgh.

Unite was the only respondent to prefer pooling and favoured it over merger as it would not lead to job losses and retained local governance structures. The remaining sixteen respondents preferred mergers and arguments concerning mergers formed the bulk of responses that preferred structural change. Two administering authorities (Lothian and Falkirk) prefer merger into two or three funds, while most of the other respondents – multi-fund employers and national employers representative groups – prefer merger into a single fund. In the views of these respondents mergers would introduce better governance of the scheme than pooling.

Respondents explored what form merged funds should take and suggested a new model for governance that abandons the administering authority model; retention of local servicing of members and employers; adoption of internal investment management to yield the greatest cost benefits; prevention of cross-subsidies by merging assets and not liabilities; and careful transition management to avoid the difficulties experienced in other public sector mergers.

Evaluating arguments and action points

Respondents offered a wealth of evidence and recommendations that should be taken up for consideration by policy makers. The Pensions Institute limits its additional analysis of the consultation findings to an appraisal of some issues raised to assist in this evaluation along with the most pressing action points.

Evaluating arguments

When making their arguments for and against the options in the consultation, most submissions indicate that the principal purpose of council pension funds was to defer workers' pay and to provide security of income in retirement at a sustainable cost to the pension scheme sponsors. Audit Scotland provided a set of criteria that could be used to judge features of the scheme most relevant to this objective.[4]

Therefore any other arguments appear of lesser relevance, or are un-useful, in informing the future structure of the SLGPS. While the structure of the SLGPS may also offer democratic accountability, provide additional resources to local authorities or enable funding of infrastructure projects, these appear to be secondary objectives and could be dealt with by other policy instruments if viewed as priorities by government.

In the case of infrastructure investment, respondents argue convincingly that it should not inform the structure of the scheme but there could be a public policy role in increasing the supply of infrastructure investments that were suitable investments for the scheme. It remains an open question whether changing the structure of the SLGPS would increase the scheme's overall investment in infrastructure assets. If funds in the scheme were large enough to internally manage infrastructure assets, this might improve the net returns and attractiveness of these investments but the scheme liabilities will ultimately determine the appropriate portfolio weighting of such assets.

With the agreement of the SAB, the Pensions Institute conducted analysis into issues raised by responses concerning: the comparability of investment management costs; the FCA findings into institutional investment management costs; and the benefits of scale.

Transparency of investment costs: Consultees differed on what investment management costs reported by the scheme under the current guidelines showed – either low costs with minor differences between funds or significant under-reporting of costs. The Pensions

[4] See the Additional Comments section in Part II of this report.

Institute finds that the scheme likely significantly under-reports costs and those reported under the current guidelines cannot be relied upon to give a good picture on how well the scheme manages investment costs.

Competition: Consultees differed on what degree SLGPS funds benefit from competition in the institutional asset management market and differed whether the Financial Conduct Authority's Asset Management Market Study show there is good competition in this market. The Pensions Institute's review of material relating competition in the UK asset management sector suggests it is not a fully competitive market neither in its retail nor institutional segments. The FCA study indicates there is weak competition in the institutional asset management market. As such the SLGPS cannot place a high degree of reliance on price competition to help control investment costs in the scheme.

Scale benefits: Consultees differed on whether large SLGPS funds could expect to enjoy scale benefits and suggested past research on LGPS funds in the UK had equivocal results. Based on a wider review of UK and international evidence, the Pensions Institute believes that it is reasonable to expect that larger SLGPS funds benefit from economies of scale in the cost of investing. In the UK, larger funds are likely to have greater buying power and command lower costs and internationally, large pension funds tend to have both lower costs and generate higher returns.

Suggested actions

In the view of the Pensions Institute, the consultation raises four top priority issues for the SLGPS.

Evaluate the case for merger: The consultation raises sufficient likelihood of benefits that the case for merger of SLGPS funds should be evaluated. This is additionally required because two funds have expressed a desire to merge, while many respondents to the consultation can say with some justification that they did not have a sufficient level of detail to properly evaluate the case for merger.

Infrastructure: The consultation suggests there is a role for the Scottish Government to play in boosting the supply of Scottish infrastructure investments that are a suitable proposition for funds and further investigation should be undertaken to how this could be done. But it remains an open question whether changing the structure of the SLGPS would increase the scheme's overall investment in infrastructure assets. An investigation into this question should compare the investment requirements dictated by the scheme's liabilities and the scheme's fiduciary responsibilities to members against the degree to which the cost savings from internal management of infrastructure assets could improve the attractiveness of these investments.

Investment costs: The SLGPS should take immediate steps to improve reporting on investment management costs. The FCA's Institutional Disclosure Working Group templates should be implemented as a mandatory reporting requirement. Costs reported under the guidelines should be publicly reported and the SAB should play a role in assessing these costs against UK and international benchmarks.

Multi-employer funds: The position of multi-fund employers appears unsustainable in the current system. Large multi-fund employers could address some operational issues by shifting to an individual fund - and legislation seems to allow for this process[5] – but this

[5] Schedule 4 of the 2018 regulations allows scheme employers to apply to Scottish Ministers to substitute membership between funds. Scottish Ministers must consult with funds and any other bodies that would be affected before granting approval. In practice, the process is managed by the Scottish Public Pensions Agency.

would not resolve the other structural issues these employers have identified relating to investment costs, governance or operating risks.

Introduction to Part I

This report summarises the responses of participants in the 2018 consultation carried out into the structure of the Scottish Local Government Pension Fund (SLGPS) by the Scheme Advisory Board (SAB).

SLGPS is Scotland's largest pension scheme with currently more than 406,000 members who are employees, former employees and pensioners. It has members in local government, education, the police, the voluntary sector, environment agencies and private contractors.

The scheme is composed of 11 individual funds with assets totalling around £42bn and liabilities to members of £55bn.[6] Each fund serves a different group of employer organisations, the largest fund is Strathclyde with £19.7bn in assets and 210,000 members; Orkney Islands is the smallest, with assets of £335m and 3,663 members.[7]

The consultation asked for views on four options for the future structure of SLGPS. These options compare the advantages and disadvantages of retaining the current structure of the scheme without change or, by degrees, consolidating the scheme's 11 constituent funds:

1) Retain the current structure with 11 funds

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

3) Pool investments between the 11 funds

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

Background

The four options were developed as part of an ongoing review into the SLGPS by SAB. The board was required to carry out the review when it was established by statute in 2015 with a mandate to provide advice to the SLGPS and the Scottish Government.[8]

In 2017, SAB's review concluded that the scheme faces a number of significant challenges and the current structure of the scheme with its 11 funds should be re-considered as a result. The findings of the review were presented to Scottish Ministers in May 2017 by SAB. In January 2018, Derek Mackay MSP, Cabinet Secretary for Finance and the Constitution requested that a consultation with SLGPS administrators, employers and employee membership bodies be carried out on the four options.

The consultation was carried out on SAB's behalf by Pensions Institute, an academic research organisation hosted by City University of London. The consultation period was June through December of 2018.

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

[7] All figures dated 31 March 2017.

[8] A summary of this review is contained in the consultation terms of reference, *Consultation on the Review of the Structure of the Scottish Local Government Pension Fund*, which can be found at SAB's website at lgpsab.scot/consultation2018.

How the findings are reported

The findings in this report are based on returns by 56 respondents and organised into two parts. This is Part I of a two part report. Part II contains detailed findings, analysis of respondents, arguments for options and additional comments.

Part I: Conclusions

Responses are summarised into findings and key issues raised by respondents are analysed.

1. **Conclusions**: The conclusions each option are summarised against the cost of investing, governance, operating risks and infrastructure consultation criteria. Reasons for supporting or opposing each option are summarised

2. **Analysis of key issues**: With the agreement of the SAB, the Pensions Institute conducted analysis into issues raised by responses concerning: the comparability of investment management costs; benefits of scale; and the FCA findings into institutional investment management costs.

1. Conclusions

Summary conclusions for each option are presented beginning with the overall case, following with findings related to the scheme criteria of investment costs, governance, operating risks and infrastructure.[9] In evaluating respondents' views, the analysis that follows is based on a qualitative assessment of the arguments made rather than on the number of respondents making a particular argument.

Option 1: Retain the current structure with 11 funds

The consultation reveals two divergent views supporting and opposing the current structure based on the scheme's approach to investment costs, governance, operating risks and infrastructure management as well as other factors such as the scheme's current settings in the form of contribution rates, net returns and funding levels.

The case for the status quo

Thirty six respondents including nine administering authorities say they prefer the status quo or a variant in the form of cooperation because the current settings of the scheme show it is success; the scheme is insufficiently flawed to justify the risks of structural change; or the case has not been made for other options. The singular position of the Strathclyde Pension Fund was also raised.

Scheme conditions: Many respondents said 'if it isn't broken, don't fix it'; the SLGPS is a success story and so the status quo should be preferred. Responses cited the scheme's funding level; scale; industry awards; costs; performance; quality of external fund managers; employee participation rates; and governance. A regional structure offered risk diversification and the ability of small funds to invest nimbly could be weighed against reduced access to economies of scale. Local ownership was a key ingredient in the scheme's performance, controlling costs and sustaining governance.

Case has not been made for other options: Respondents said that there was insufficient empirical evidence of the benefits of scale in investment costs or performance from the other options to justify the risks to investment performance, member participation, funding, employee contribution rates, or local conditions. This perceived lack of evidence applied to analysis of scale benefits of funds in the scheme currently, the experience from pooling in the England and Wales LGPS, and other options in the review. As part of this, some responses said several smaller and medium funds already enjoyed scale benefits so other options presented insufficient advantages to justify change. Changing the structure of the scheme would not resolve all the challenges it faces currently; earlier reforms needed time to bed in and incremental changes were preferable.

Strathclyde: Several responses noted that Strathclyde Pension Fund with £21.5bn in assets had a singular position as the scheme's only very large fund – or largest fund by a considerable margin. Scale benefits for Strathclyde were seen as limited, the fund could already directly invest in infrastructure and the fund itself suggested that additional scale could bring diseconomies.

The case for changing the status quo

[9] More detailed conclusions are contained in the Findings section of Part II of this report.

Seventeen respondents, including nine administering authorities, the two unions, five multi-fund employers and representatives of admitted bodies says the system is not optimal, has significant flaws and should be abandoned in favour of pooling or merger. All scheme members should have access to the benefits of scale and the scheme's regional structure was a disadvantage.

Status quo not optimal: Responses acknowledged the stable financial position of the scheme but argued that this was not optimal, with rising contribution rates, falling employer participation, treatment of cessation liabilities, conflicts of interest caused by the administering authority model and the protection of benefit levels being of particular concern. The fiduciary duty of funds should compel them to actively consider if alternative structural options best serve their members. The current stable financial position of the scheme presented a better time for structural change than in response to a crisis.

Benefits of scale: Respondents argued that smaller funds in the SLGPS did not benefit from lower investment fees and other economies enjoyed by the scheme's large funds, such as the ability manage funds in-house, hire skilled employees to manage operating risks or to directly invest in complex assets such as infrastructure. Smaller funds were seen as less able to deal with challenges facing the scheme relating to governance, reporting, rising regulatory overheads and operating risks.

Disadvantages of regional structure: Responses said the regional structure of the scheme had disadvantages and was a particular problem for multi-fund employees and third-sector admitted bodies. A regional structure was seen as a barrier for funds to implement best practices, apply consistent policies and access specialist skills as well as heightening funds exposure to budgetary and conflict of interest risks from administering authorities. A regional structure posed high interaction costs for multi-fund employers and they were at risk of being treated as closed employers in funds where they had few employees.

Findings: Investment costs

Investment costs in the SLGPS are uncertain: Although managing investments currently generates more than 90% of the scheme's costs on some estimates, the consultation suggests the SLGPS currently does not have a good gauge of the fees it pays to external managers and evidence presented suggests that larger funds should, in principle, be better able to manage costs and enjoy scale benefits.

Some arguments for the status quo assume costs reported by the scheme are accurate: Supporters of the status quo say that data reported by funds and collated by Audit Scotland show costs are low, stable and that variations between funds are minor and unimportant. Costs are low and stable because fees from external fund managers are kept under control by the scheme's administrative arrangements and competition in UK institutional asset management market.

Costs are likely under-reported in the SLGPS: Opponents say that external management costs currently reported cannot be relied on because the CIPFA guidelines used by the scheme are inadequate and as a result, the SLGPS significantly under-reports costs. If more transparent data were available, costs would be shown to be much higher. Small, basis point differences in fees were shown to be significant because they lead to million pound differences in costs.

The Pensions Institute's review of material relating competition in the UK asset management sector suggests it is not a fully competitive market neither in its retail nor institutional segments.[10] As such the SLGPS cannot place a high degree of reliance on price competition to help control investment costs in the scheme.

The Pensions Institute's review suggests that the fees disclosed by asset managers in the UK are not transparent and therefore the SLGPS cannot rely on the data currently reported under the system to assess how well the scheme manages investment costs or make comparisons between funds.[11] Costs are likely under-reported. However, this situation is likely to improve if the scheme and funds adopt the Institutional Disclosure Working Group templates.

Larger funds have advantages in procuring investments over smaller funds: Despite the scheme's administrative controls, larger funds with more resources and buying power should be able to command lower fees from external managers who customarily charge fees in tiers with lower fees for larger mandates. Larger funds could also choose to manage funds internally at a significantly lower cost than fees charged by external managers.

Based on our review the Pensions Institute believes that it is reasonable to expect that larger SLGPS funds benefit from economies of scale in the cost of investing. In the UK, larger funds are likely to have greater buying power and command lower costs and internationally, large pension funds tend to have both lower costs and generate higher returns. Although pension funds can become subject to diseconomies of scale, SLGPS funds in aggregate are small on an internationals scale, and are therefore unlikely to reach the threshold where these dis-benefits would apply.[12]

What the scheme could do better: Respondents generally agreed that the scheme could improve reporting on investment management costs. Compliance with existing reporting guidelines should be mandatory, some suggested reforms to CIPFA guidelines and most agreed investment costs of all funds should be publicly shared and benchmarked.

Findings: Governance

Regional governance of SLGPS is not optimal: The consultation suggests that the SLGPS is good at adhering to the governance requirements presented to it through local government acts and regulations, but there are problems created by the scheme's model of governance by administering authorities with lead employers along regional lines.

Scheme is largely compliant: The evidence presented suggested that the scheme as a whole is in compliance with its existing legislative and regulatory requirements. Key items were the absence of issues raised in annual audits of LGPS funds by Audit Scotland and the positive outcome of the 2016 KPMG review.

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[10] See the report section: *Key Issue: Competition in investment management for LGPS funds*

[11] See the report section: *Key Issue: Transparency of investment costs*

[12] See the report section: *Key Issue: Scale benefits and the SLGPS*

Some believe the regional system manages conflicts and provides local benefits: Views diverge on the effectiveness of the SLGPS model of governance. Supporters of the status quo said the current regional model ensures local participation and provides administering authorities and their regions with economic benefits from the funds' administrative activities, in particular, through employment of those working for the funds and mitigates any potential conflict in the dual role of administering authorities as pension fund managers and employers. A mixture of training, external advice, administrative support and the introduction of pensions boards ensured the scheme had the expertise required for governance.

But local benefits are secondary to providing pensions: However, in the course of responding, most submissions said that the principal purpose of council pension funds was to defer workers' pay and to provide security of income in retirement at a sustainable cost to the pension scheme sponsor. While the structure of the SLGPS may also offer democratic accountability, provide additional resources to local authorities or enable funding of infrastructure projects, these appear to be secondary objectives to this main goal. Therefore, they appear of lesser relevance in informing the future structure of the SLGPS. Audit Scotland provide a set of criteria that could be used to judge features of the scheme most relevant to scheme's objectives of using deferred pay to provide security of income in retirement.[13]

Administering authority model is problematic: Submissions also suggested the administering authority model gave an outsize role in governance to administering authority 'lead' council employers, who hold the majority of pension committee seats, and could lead to unresolved fiduciary conflicts. Council policies can directly affect the governance of funds by dictating board hiring practices and the budgets available to administer funds. It was suggested that the capabilities of pension boards and committees fluctuate with the electoral turnovers of councillor members. Multi-fund employers said that the regional differences made it difficult to participate in governance and charities said it led to inconsistencies in the treatment of employers in the form of arrangements for cessation liabilities for admitted bodies.

Findings: Operational risks

Most respondents generally believed they had access to information about operating risks of the funds in the SLGPS and were well informed. Where respondents felt they were less well informed, it was because they were employers with insufficient resources to monitor funds, or because they were aware that smaller funds may have fewer internal resources to manage operating risks.

Persisting skills concerns: Respondents believe the SLGPS has strong controls, systems and processes, but some identified concerns with the availability of skills and use of external advice. For example, some funds relied on investment strategy advice from external fund managers.

Regional structure: Respondents were divided on whether each fund having its own approach to operational risk management helped or hindered, while significant issues with the treatment of cessation/termination liabilities for admitted bodies were raised.

Improvements: Respondents proposed various ways of improving operational risk management including: standardisation and benchmarking of risk reporting; benefits simplification; improvements to staffing, processes and systems; and mandated consistent adoption of cessation reporting standards and liability accrual.

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[13] See the Additional Comments section in Part II of the report.

- *Standardised reporting:* Respondents proposed greater standardisation and disclosure of the risk register and fund performance reporting, including a framework of standards expected of the SLGPS to measure performance against. It was also proposed that SAB should collate and publish risk registers annually.

- *Benefits simplification:* Many respondents suggested simplifying benefits regulations as reducing operational risks, citing the complexity involved in administering three benefit schedules (1/80th, 1/60th, 1/49th), differing discretions, 30 contribution rates, certificates of protection and aggregation rules.

- *People, processes and systems:* Respondents suggested systematic sharing of best practice; greater training and better management of key person risks, variously for governance personnel, administrators, decision makers and members of SAB. Administering authorities could gain benchmarking information by consolidating their use of the Aquila Heywood Altair LGPS software onto the cloud.

- *Cessation/termination regulations*: Robertson Trust and SCVO recommended better transparency and communication for the treatment of cessations. This includes implementing the proposals made by the Institute of Chartered Accountants of Scotland in September 2017 and requiring funds to act on updated LGPS legislation in 2018. Funds should provide admitted bodies with an estimated cessation valuation and explanation in line with FRS102 disclosure requirements.

Findings: Infrastructure

Responses largely recognised the benefit to funds of investing in infrastructure – in particular, for funds with mature liabilities to match against the lower risk, long-term, inflation-linked income of infrastructure investments. But they were clear that, although there was a policy role of increasing the supply of suitable infrastructure investments, they were opposed to any political interference that would conflict with the aims of the scheme and its fiduciary duties.[14]

Larger funds have better access: Responses suggested that larger funds had better, or cheaper, access to infrastructure investment. Collaboration was presented as a means for smaller funds to gain access to infrastructure.

Improving availability of infrastructure: Many responses suggested improving the supply of investments that were a 'suitable proposition' for funds and providing vehicles accessible by small funds. This included looking at Scottish Futures Trust proposals on pooled housing infrastructure investments, or a role for government establishing investment vehicles that provided the risk-return characteristics required by funds. Direct cooperation with public bodies that might require infrastructure finance was mooted.

Suggested actions:

Investment costs: The SLGPS should take immediate steps to improve reporting on investment management costs. The FCA's Institutional Disclosure Working Group templates should be implemented as a mandatory reporting requirement. Costs reported under the guidelines should be publicly reported and the SAB should play a role in assessing these costs against UK and international benchmarks.

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[14] Respondents said that raising the scheme's investments in infrastructure should not be used as a criteria to inform any option for the future structure of the SLGPS.

Multi-employer funds: The position of multi-fund employers appears unsustainable in the current system. Large multi-fund employers could address some operational issues by shifting to an individual fund - and legislation seems to allow for this process[15] – but this would not resolve the other structural issues these employers have identified relating to investment costs, governance or operating risks.

Infrastructure: The consultation suggests there is a role for the Scottish Government to play in boosting the supply of Scottish infrastructure investments that are a suitable proposition for funds and further investigation should be undertaken to how this could be done. But it remains an open question whether changing the structure of the SLGPS would increase the scheme's overall investment in infrastructure assets. An investigation into this question should compare the investment requirements dictated by the scheme's liabilities and the fiduciary responsibilities to members against the degree to which the cost savings from internal management of infrastructure assets could improve the attractiveness of these investments.

[15] Schedule 4 of the 2018 regulations allows scheme employers to apply to Scottish Ministers to substitute membership between funds. Scottish Ministers must consult with funds and any other bodies that would be affected before granting approval. In practice, the process is managed by the Scottish Public Pensions Agency.

Option 2: Cooperation

Cooperation was preferred by many respondents because it was a means of preserving the current structure of the scheme, while potentially offering a route to yield some improvements in investment costs, governance, operating risks or the scheme's capacity to invest in infrastructure.

But funds leading cooperation efforts suggested it was difficult to scale and could require participants to relinquish control over investment decisions and adopt internal investment management. Others said cooperation retains the disadvantages of a regional structure and could be sub-optimal compared to pooling or merger. Some said the limited extent of cooperation in the current system despite its apparent benefits, may show that reforms to the SLGPS need be compulsory.

The case for cooperation

Respondents said cooperation offered benefits to smaller funds through reductions in costs and sharing of resources. Some said that existing collaboration between funds or participation in national frameworks showed that the cooperation model worked for the SLGPS. But there were differences between respondents in how cooperation could be pursued:

Incentivised or compulsory: Many respondents said cooperation should be pursued for its benefits either, in its own right, or, in tandem with structural change, but only in conjunction with incentives or compulsion to ensure all funds were actively engaged. Otherwise it would just reflect the status quo and not yield any change to the SLGPS. Many respondents who were otherwise supportive of the status quo in the SLGPS felt that incentives or compulsion was necessary for cooperation to be of benefit, while respondents who preferred pooling or merger said compulsory cooperation could yield significant benefits in the short-to-medium term while structural change was implemented. The Robertson Trust–SCVO response suggested that existing cooperation between funds was in fact relatively limited despite clear benefits suggesting compulsion was required.

Reflects the status quo: However, some respondents preferred cooperation because it represented the status quo. They felt cooperation should be voluntary, or incentive based, as it gave them the greatest degree of freedom to address their members' interests. Voluntary cooperation would also avoid the disadvantages of pooling or merger, revisiting a reason for supporting Option 1 that there was apparently insufficient empirical evidence of the benefits of scale in investment costs or performance from the merger or pooling to justify the risks to investment performance, member participation, funding, employee contribution rates, or local conditions.

Frameworks to assist cooperation: Several responses, including Strathclyde Pension Fund, suggested some re-organisation of the scheme could assist cooperation. Key elements in the Strathclyde response include: an active programme to promote joint investment, procurement and resource sharing; joint activity on ESG issues; shared administration and communications; additional resources for SAB or funds; a formal fund conveners' meeting; and establishment of three hubs for the north, west and east of Scotland. Additional suggestions for cooperation outside this framework included administrative activities such as publishing; joint procurement of the Aquila Heywood Altair Pension Administration system and member education. Respondents also suggested beefing-up SAB to add impetus to cooperation, and although the means were not specified, it was suggested the board have a greater ability to compel funds to participate in cooperation frameworks or adopt transparency measures.

The case against cooperation

Respondents identified problems for cooperation, including that it could be difficult to scale, could require additional funds before it would be economic to adopt internal management, retains regional disadvantages and could be sub-optimal compared to pooling or merger.

Scaling problems: The Lothian model of cooperation was frequently cited as evidence that the SLGPS could pursue cooperation to the benefit of the scheme's investment costs, governance, operating risks and infrastructure investment. But some participants in the arrangements had doubts whether the Lothian model could scale widely in the scheme. Respondents said cooperation took significant time to establish and required a high degree of delegation that could be unpalatable to some funds. The Lothian Group[16] felt that a significant element of its cooperation arrangements – the joint investment strategy panel with the Falkirk and Fife funds – would not scale beyond its existing membership of three participants. Other responses suggested that separating fund governance from administering authorities – an independent executive – would be necessary for this cooperation to be scalable.

Requires funds to adopt and share internal investment management. Edinburgh Leisure suggested that because 92% of fund costs are investment management fees, cooperation would be sub-optimal unless funds brought investment management in-house and then shared their internal managers as part of cooperation agreements. This was also true for pooling and mergers. The response recognises that most funds are too small to bring funds in house, so a potential implication of this response is that one or more additional large SLGPS funds would need to bring funds in-house, otherwise any cost saving from cooperation would be limited.

Doesn't address the disadvantages of regional structure: Multi-fund employers suggested that, unless cooperation led to homogeneity between funds with a single point of administrative contact, it would not resolve their difficulties with the high interaction costs caused by the regional footprint of the scheme nor the risk of being treated as closed employers.

Sub-optimal compared to other options: Some respondents acknowledged the benefits of cooperation, but said it still remained sub-optimal compared to pooling or mergers. These revisited the arguments presented against the status quo in Option 1, including that it was better to make changes to the scheme under good conditions and that scale benefits were not enjoyed by all participants in the current set-up. There have been some very impressive attempts to make small changes on a cooperative basis, as the Lothian model shows. But, equally, Lothian also shows the limits to the cooperation model, in particular, the difficulties in scaling up. The Robertson Trust–SCVO response confirms what must be the reality: the existing cooperation model is 'in fact relatively limited despite clear benefits suggesting compulsion was required'.

Findings: Investment costs

On balance, responses suggest that cooperation would have limited impact on reducing the investment costs of the scheme, unless highly specific forms of cooperation were adopted involving one or more funds making available their internal investment management function to others in an arrangement that bears a marked similarity to pooling. Other forms of cooperation were likely to be of most benefit to smaller funds, but these were the funds with the least capacity to enter into cooperation.

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[16] Joint response by the Lothian Pension Fund executive, Lothian Pensions Board and Pensions Committee of City of Edinburgh

Findings: Governance

Respondents agreed funds would need to align their governance structures to pursue cooperation, perhaps to the extent of delegating investment strategy implementation and fund manager selection. Such structures could dilute local governance and shift more decision-making authority to executives. Cooperation may not reduce governance overheads, but some responses suggested additional benefits through shared resources.

Findings: Operating Risks

Responses produced little consensus on whether cooperation would improve or worsen the management of operating risks in the scheme. Although funds could rely on their existing arrangements to manage operating risks from cooperation; it was uncertain whether clubbing together with others would yield efficiency or effectiveness benefits; and there were a set of new risks to manage, mostly in relation to preventing the failure of governance agreements.

Findings: Infrastructure

Respondents were uncertain whether cooperation would increase direct infrastructure investment by the scheme. Incentives, such as model arrangements would be required to increase investment by large funds, which already had substantial investments. Although cooperation would likely assist smaller funds to access direct investments, this might not be by a significant magnitude in relation to the scheme as a whole. Care would need to be taken managing potential conflicts of interest relating to local investing.

Option 3: Pooling

The case for Option 3: Pooling

Unite was the only respondent to prefer pooling, but several respondents discussed the case for pooling; some describing it as a minimum required reform. Unite preferred pooling over merger in that it would not lead to job losses; allowed spreading of risks; improved SLGPS buying power; retained local governance structures; and reduced administration costs. When discussing the case for pooling, key considerations respondents discussed were:

Single or multiple pools: Respondents differed on whether there should be single or multiple pools. Unite preferred three or four pools, other respondents suggested that pools would need to at least £25bn in size to gain investment scale benefits, the Police Scotland–Police Authority Scotland response suggested a number of pools that would allow for the different investment strategy needs of funds in the scheme. This response gave as an example funds with a stronger funding position preferring a pool with a low risk investment strategy. Some respondents who preferred multiple pools also said a single pool could have more challenging governance requirements. The Robertson Trust–SCVO response suggested that a single pool at £42bn in assets would not be excessively large. It would be roughly double the size of the existing largest fund, Strathclyde, but similar in scale to three of the English pools and larger than the three of the others.

Voluntary or compulsory: Some respondents supported the idea that pooling could be promoted as a voluntary option where it met the requirements of different funds. Strathclyde Pension Fund for instance, already enjoys scale benefits so should not need to pool. Other funds might need the freedom to select pools with complementary risk-return profiles or to access specific asset classes such as infrastructure. It was not clear how voluntary pools should reach the thresholds where scale benefits became available.

Governance, costs and internal management: Responses suggested that pooling would need to be internally managed to deliver meaningful cost reductions and prevent overly bureaucratic governance. Unite's response said that lack of oversight and control in governance, and lower-than-expected cost savings in England and Wales showed that pools in Scotland should be internally managed. Other respondents said not implementing an additional layer of governance between the fund and the investment manager was the key for pooling to have more success than England and Wales. Edinburgh Leisure's argument relating to cooperation applied, which because investment management fees make up 92% of scheme costs, meant pooling would be sub-optimal unless funds brought investment management in-house.

The case against Option 3: Pooling

Arguments against pooling suggested that the scheme conditions didn't justify change; the case hadn't been made for pooling; internal management offered surer cost savings; pooling could lead to national concentration of risks; and pooling didn't resolve admitted bodies' problems with cessation.

Scheme conditions: Respondents revisited the 'if it isn't broken, don't fix it' position in favour of Option 1 that the SLGPS is a success story and so the status quo should be preferred.

Case has not been made for pooling: Some respondents said that they hadn't been presented with a clear case that allowed them to evaluate the advantages and disadvantages of pooling and so it was not possible to make an informed response. In general, respondents revisited the argument in favour of Option 1 that that there was

insufficient empirical evidence of the benefits of scale in investment costs or performance from pooling to justify the risks to investment performance, member participation, funding, employee contribution rates, or local conditions.

Respondents said that pooling in England and Wales suffered from a lack of a standardised approach or clearly planned strategy; lower-than-expected savings; long payback periods; stripping of skilled employees from administering authorities to set up pools; and significant governance problems. The structure of the SLGPS where one fund – Strathclyde – holds roughly half the assets was said to be significantly different that evidence in England and Wales might not apply. Although a Scottish approach to pooling was being developed by the Scottish Futures Trust, it was focused on infrastructure and property and in its infancy.

Internal management should be pursued first: Some responses thought the SLGPS should focus on moving management in house as a surer means to generate cost savings than pursuing pooling.

Concentration of risk versus benefits of regional diversity: Some respondents suggested pooling could create a single point of failure for the SLGPS and that the existing regional structure offered diversification benefits.

Retains segregated liabilities, so leaves cessation issues unresolved: The Robertson Trust-SCVO response said pooling would not resolve the cessation issues encountered by charitable and admitted bodies because pooling would preserve specific employer responsibility for liabilities with funds retaining their allocations of assets and liabilities.

Findings: Investment costs

On balance, responses suggest that pooling would most likely deliver savings if it were based on internal management of pools or if pools were large enough to reach the lower fee thresholds of external managers. If pools were to be externally managed, they might benefit small funds only. Many respondents couldn't foresee any cost savings; some said there was an absence of evidence for benefits, or thought pooling could lead to market concentration and reduced investment effectiveness.

Internally managed pools: The Lothian Group said internally managed pools could offer significantly lower costs than externally managed pools. The group suggested if pools achieved the costs of the Lothian Pension fund, SLGPS investment costs would be 80% lower leading to substantial cumulative benefits. If the SLGPS pools could lower their expense ratio from 0.47% currently to the level of the University Superannuation Scheme at 0.31% then the scheme could save £65m annually.

Externally managed pools: Externally managed pools would most likely be of benefit to small or medium funds by lowering costs or broadening portfolios. But large funds would be unlikely to benefit: Strathclyde Pension Fund said it already pays the lowest fee tier offered by external managers. Responses indicate externally managed pools would also need to exceed particular thresholds in particular assets classes to reduce costs and thus would need to be compulsory. Falkirk Council Pension Fund gave as an example an external manager fee quotation of 0.54% for a £100m global equity strategy mandate and 0.39% for a £1b mandate. Others suggested a minimum size of £25bn for scale advantages based on the experience of LGPS pooling in England and Wales

Findings: Governance

The complexity of pool structures potentially raised governance issues; respondents disagreed on whether these could be resolved, but Scotland could learn from the experience in England and Wales. Overall, responses balanced the benefits of retaining local influence and stakeholder involvement, while gaining skilled resources and scale by pooling against risks associated with complexity; retention of duplicate structures and diseconomies of scale.

Pooling could allow the scheme to retain existing local governance arrangements but at the cost of maintaining duplicate governance structures. Under pooling, investment decisions could improve with the benefit of greater specialist influence or worsen through complexity and insufficient granularity. Savings from the operation of pools in the long-term would need to be sufficient to absorb the set-up and running costs of pools. Pooling could introduce new governance risks, including internal manager capture and dilution of stakeholder influence in favour of executives.

Findings: Operating Risks

Overall responses were unclear whether pooling raised or lowered operating risks. Potential new risks were identified in setting up pools, oversight and investment strategy, but so were risk reducing factors in access to staff with specialist skills, manager selection processes and diversification.

Findings: Infrastructure

Respondents thought pooling might not create additional capacity in the SLGPS to invest in infrastructure, but could lead to higher investment as pools could offer greater scale and better packaged investments to suit scheme funds.

Creating new pools for SLGPS funds: Respondents discussed the merits of creating new infrastructure pools dedicated to SLGPS funds as opposed to pooling funds in their entirety. Some respondents suggested such pools could provide investments packaged to meet the risk, inflation and maturity characteristics desired by SLGPS funds; sources for this idea included the Pensions Infrastructure Platform and the Scottish Futures Trust report which suggested that Scottish real estate might be a good investment for LGPS funds.

Option 4: Merger

The case for mergers

Some 16 respondents suggest the SLGPS fund should merge because it would lead to benefits for investment costs, governance, operating risks and infrastructure investment. The two administering authorities (Lothian and Falkirk) prefer merger into two or three funds, while most of the other respondents - multi-fund employers and national employers representative groups prefer merger into a single fund. They offered the following additional considerations on mergers:

Compulsory mergers when a business case was present: Some respondents said that funds could be directed to merge if a business case, risk assessment and due diligence that demonstrated merger would be in the best interest of all members and employers. This business case should include timescales, costs of implementation and modelling of the impact on the affordability of the LGPS in the medium–long term, as well as analysis of the impact on the funding levels of the schemes, including the actuarial basis of the analysis and the funds' demographic profiles. This analysis should focus on the net bottom line impact on the fund and ensure no diminution in service levels to employers.

Voluntary mergers when a business case is present: Some respondents said voluntary mergers should be encouraged until the Scottish Government chose to make them compulsory. Lothian Pension Fund and Falkirk Council Pension Fund Two said they wished to build business cases and explore mergers between the funds. If a policy of voluntary mergers were pursued, then it was proposed the SAB should schedule a review in five years that would lead to enforced mergers for funds that cannot meet best practice standards set by the body

Status quo not optimal: As with Option 1, responses acknowledged the stable financial position of the scheme but argued that this was not optimal, with rising contribution rates, falling employer participation, treatment of cessation liabilities, conflicts of interest caused by the administering authority model and the protection of benefit levels being of particular concern.

Benefits of scale: Respondents suggested that fund mergers had been successfully conducted in the past so the model was in fact tested. The merger of county and town council funds during local government re-organisation in 1975 and the creation of the South Yorkshire Pensions Authority were cited as examples. As with Option 1, respondents argued that mergers should be pursued because some funds in the SLGPS did not benefit from lower investment fees and other economies enjoyed by the scheme's large funds, such as the ability manage funds in-house, hire skilled employees to manage operating risks or to directly invest in complex assets such as infrastructure.

Preferable to pooling due to governance: Respondents said mergers were preferable to pooling because they did not introduce an additional governance layer which came with the potential for poorer or less accountable decision-making.

Resolves disadvantages caused by regional structure: As with Option 1, respondents said merger could resolve the difficulties caused by the scheme's regional structure including consistency issues for admitted bodies, administrative issues for multi-fund employers, and the risk of multi-fund employers being treated as closed employers in funds which they had fee employees.

The case against mergers

In making the case against mergers, respondents said the scheme favourable conditions meant change was not necessary and a detailed case for merger hadn't been presented to them. They said mergers could lead to cross subsidisation of liabilities; loss of local governance; reduced administrative capacity and had a high risk of failure in the public sector.

Scheme conditions: Respondents revisited the 'if it isn't broken, don't fix it' position in favour of Option 1 that the SLGPS is a success story and so the status quo should be preferred.

Case has not been made for merger: Some respondents said that they hadn't been presented with a clear case that allowed them to evaluate the advantages and disadvantages of merger and so it was not possible to make an informed response.
In general, respondents revisited the argument in favour of Option 1. Strathclyde Pension Fund said that size and scale benefits were not necessary a determinant of success. The UK's two largest pension schemes – British Telecom Pension Scheme and USS – each had deficits of more than £10bn.

Cross subsidisation of liabilities: The potential for cross subsidisation of liabilities to raise contribution rates for employers of better funded funds was a significant concern for many respondents. Some respondents said that employers were highly sensitive to contribution rates so increases could lead to job losses or a reduction of employers in the scheme.

Loss of local governance: Respondents said mergers would reduce their participation in governance and that a merged scheme could lead to lower participation from particular stakeholders such as admitted bodies, employers and unions. Some said that local governance was integral to the successful performance of funds.

Reduced administrative capacity: Some respondents said mergers could make it difficult for former administering authorities to manage other financial matters.

The public sector is unable to conduct mergers effectively: Respondents said that public sector mergers perform poorly and this risk was high for mergers in the SLGPS due to the scheme's administrative complexity.

Findings: Investment costs

Respondents presented some analysis on how mergers could reduce investment costs, but many said they had not seen practical evidence or required a more detailed case before they could make an informed evaluation.

Case for economies: The Lothian Group[17] estimated the scheme could make annual savings of £65m, leading to cumulative gains of £1bn by year 10, if merged funds adopted internal management like other large funds globally, bringing costs in line with the expense ratio of the UK's largest fund – the Universities Superannuation Scheme. Although the largest fund – Strathclyde – may not benefit, other funds could also gain access direct investments which previously had high entry costs and reduced the use of expensive investment vehicles. Falkirk Fund with £2.3bn in assets said that every reduction in fees of 5bps (0.05%) translated into annual saving of c£1.2m. UNISON cited the APG study suggesting the

[17] Lothian Pension Fund executive, Lothian Pensions Board, Pensions Committee of City of Edinburgh

presence of a single merged fund in Scotland would have deliver annual benefits of £830m with each basis point saving the scheme £3.5m.

Case against economies: Some respondents suggested that there was insufficient evidence that larger funds had lower costs or produced better returns than smaller funds and there was no certainty to where the tipping point where economies of scale could be achieved, so mergers did not guarantee real benefits. SLGPS funds may already enjoy scale benefits or have benefited from fee savings passed on from reforms in England and Wales. The SAB's snapshot analysis of the LGPS 2015 accounts by Mercer for the SAB was cited as showing that larger funds do not always have lower costs and perform better and Audit Scotland analysis of fees were said to show that SLGPS funds did not have significantly different investment costs.

Findings: Governance

Responses contrasted the benefits for governance of the greater resources available to large funds, and consistency of approach, against the potential for a loss of input by regional stakeholders. Larger merged funds might enjoy improved governance as they were better resourced and the scheme as a whole might benefit from greater consistency of governance from a fewer number of large funds. The new governance structures of merged funds might share governance among a wider set of stakeholders than currently. But some said merged funds might allow less local input and reduce the influence of particular stakeholder groups such as employers. the current governance arrangements could be intrinsic to the successful performance of funds.

Choice of governance model: Respondents said merged funds would need new governance structures and suggested joint boards or a pensions authority as models. The model chosen would depend on whether the scheme merged into a single or reduced number of funds. Reducing the dominance of administering authority councils and the inclusion of other councils and employers was seen as a benefit of this approach.

Findings: Operating Risks

A scheme with merged funds could have better resources to manage operating risks than it does currently, but some said a trade-off could be greater concentration of risks. The merger process would carry execution risks, including administration and member servicing concerns that would require a management strategy. Former administering authorities may face risks caused by loss of financially knowledgeable staff.

Findings: Infrastructure

Respondents disagreed on the impact mergers would have on infrastructure investment by the scheme. Although larger funds might have a greater appetite for infrastructure, the scheme could already be investing close to capacity with additional gains limited. Merged funds could be subject to diseconomies and political risks. Public policy measures would be needed to generate the larger scale infrastructure investments that merged funds might require.

Findings: Considerations for mergers

Respondents explored how mergers should be conducted, what form merged funds should take and the best number of merged funds for the scheme. Among the key considerations were:

- *Governance*: A new model would be required and merged funds should abandon the administering authority model.

- *Local servicing*: To retain administrative effectiveness, merged funds should retain local servicing of members and employers.

- *Internal management:* Mergers are likely to yield the greatest benefits if funds are managed in-house.

- *Merger into a single fund or two to three large funds*: A single fund would be of international scale and able to access global best practices, while merger into two to three funds might retain a degree of local autonomy.

- *Prevention of cross-subsidies:* Mergers of the SLGPS should protect the funding positions of existing employers, so those in better funded schemes should not face a rise in contribution rates as a result of merger from funds with lower funding levels.

- *Management of execution risks:* Mergers would need careful transition management and appropriate resourcing to avoid difficulties experienced in other public sector mergers.

Suggested actions:

Evaluate the case for merger: The consultation raises sufficient likelihood of benefits the case for merger of SLGPS funds should be evaluated. This is additionally required because two funds have expressed a desire to merge, while many respondents to the consultation can say with some justification that they did not have a sufficient level of detail to properly evaluate the case for merger.

2. Analysis of key issues

The Pensions Institute is very pleased to be involved in this consultation exercise. We appreciate the thoroughness of the responses. We see our main role as summarising the responses in a neutral and objective way. Our analysis is based on a qualitative assessment of the arguments made rather than on the number of respondents making a particular argument.

Nevertheless, with the agreement of the SAB, in this section we critically appraise some of the arguments presented and provide some empirical evidence on some of the issues raised. These are not intended to be a recommendation on which of the options is best suited for SLGPS but to assist in evaluating the arguments and issues raised.

The Pensions Institute, conducted additional analysis into issues raised by responses concerning:

1. How comparable are the investment management costs currently reported in the scheme?

2. To what degree do LGPS funds benefit from competition for institutional investment management costs?

3. How reasonable is it to expect scale benefits for large LGPS funds?

Key Issue: Transparency of investment costs

How comparable are the investment management costs currently reported in the scheme?

The Pensions Institute's review suggests that the fees disclosed by asset managers in the UK are not transparent and therefore the SLGPS cannot rely on the data currently reported under the system to assess how well the scheme manages investment costs or make comparisons between funds. However, this situation is likely to improve if the scheme and funds adopt the Institutional Disclosure Working Group templates.

The UK asset management market was placed under the regulatory microscope following the 2008 financial crisis which raised questions about the value of the sector to the wider economy.[18] The management of assets held on behalf of institutions has come in for special scrutiny both in the UK and internationally.[19] The sector's reporting of costs and fees has been subject to new regulation stemming from MiFID II and the Asset Management Market Review along with many other aspects of the asset management market including stewardship, governance[20] and competition.

Following this regulatory programme, which is still ongoing, there is now a broad consensus that the disclosure of costs and fees by the UK asset management market is not transparent. In the context of the SLGPS, these findings are sufficiently clear to remove the ambiguity

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[18] For example, The Kay review of UK equity markets and long-term decision making, Final Report, July 2012.

[19] https://www.fca.org.uk/publications/market-studies/asset-management-market-study; https://www.esma.europa.eu/policy-rules/mifid-ii-and-mifir

[20] http://redlinevoting.org/

created by earlier work analysing the costs and fees of scheme funds which could be critiqued on the quality of their data and the time periods of analysis.[21]

The transparency issues identified by the regulatory programme have implications beyond reporting. One implication is that UK institutions cannot make completely informed choices about asset allocation based on information received about costs and fees. Trustees cannot be certain whether any mandate that they are selecting genuinely offers value for money, or have confidence that the investment will perform in the way in which they expect – i.e. whether the expected returns will be lower as a result of costs and fees that are opaque.

Explicit and implicit costs

The information set that most trustees receive reports the explicit costs of fund management such as the Total Expense Ratio (TER) but in most cases fails to fully include all implicit elements in granular detail including custodian fees, exchange fees, bid-ask spread etc. This is not solely a reporting issue because there is evidence that fund managers themselves may not be aware of the trading costs of fund management.[22]

Among the high profile examples of hidden implicit costs example is the unbundling of research fees as the result of MiFID II. Historically, research costs were simply charged against client assets. With the new regulation, EU portfolio managers are required to either bear research costs directly from the firm's own resources, or, if they choose to charge clients for research, then they must adequately disclose and account to their clients for that expenditure[23]. In response, most asset managers have now chosen to bear research costs directly[24]. However, as these were historically charged against client assets, this was an income stream to the asset manager and by extension a hidden cost to the pension fund that reduced fund performance.

To highlight the impact of even modest differences implicit costs it is instructive to look at a research into defined contribution (DC) schemes which have fewer of the elements of defined benefit schemes that obfuscate costs – including the ongoing nature of a scheme and scheme solvency factors such as changes in life expectancy. In relation to a DC scheme, the Office of Fair Trading showed that a 1% per annum charge over 40 years will reduce the assets available for the purchase of an annuity by 21%.[25] This erosion is significant, and in the context of a DB scheme, would result in increased contributions from members and employers to make up any shortfall.

Taken together, the combination of opaque fee structures and the compounding effects of costs through time, mean that for relatively small changes in the cost of asset management, there can be a significant impact on the performance of a pension fund and its ability to pay pensions.

Cost transparency in the SLGPS

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[21] See, APG Group, Performance Analysis of the LGPS; Deloitte, Pathfinder Report; and Mercer, Investment Structure Review, Scottish LGPS Scheme Advisory Board Working Group.

[22] Lane Clarke and Peacock, 2013, Investment management fees survey.

[23] https://www.pwc.com/gx/en/advisory-services/publications/assets/the-future-of-research-mifid-ii.pdf

[24] "The definitive list of asset managers that will pay for research", *Financial Times*, February 22, 2018.

[25] Defined contribution workplace pension market study, Office of Fair Trading, 2013.

This is not to ignore reforms in the reporting of investment management costs in the scheme which have been significantly improved by the Chartered Institute of Public Finance and Accountancy's (CIPFA's) new accounting standard and the LGPS Transparency Code. However, despite these improvements there are still likely to be significant costs that remain opaque and the extent to which consistency across funds has been achieved remains an open question.

The new CIPFA standard requires funds to report many more costs than under the old standard, which only required LGPS funds to report on invoiced fees. The impact of this most clearly seen in the West Midlands Pension Fund. Under the old standard of invoiced fees, WMPF reported £11.3m of costs in 2012/13, and £11.2m in 2013/14. However, after applying the new standard, its costs rose to £87.3m[26] and so much greater transparency was achieved.

But as the current CIPFA guidance requires the listing of management and performance fees together with transaction and custody costs this leads to at least two scenarios which could result in under reporting:

1. The LGPS fund has not asked for or received information on costs recovered from net return and is therefore only reporting on invoiced fees

2. The accounting standard requires the exclusion of indirect costs from the figures reported in the accounts

The new CIPFA guidance for 2019-20 will seek address these scenarios by requiring LGPS funds to state the extent of their use of the LGPS Code of Transparency in formulating their reported costs, and by enabling the inclusion of indirect costs in the report section of the document.

The SAB has adopted the Transparency Code developed by the LGPS in England and Wales for asset managers to sign up to. Originally, this was a template designed in conjunction with CIPFA, investment managers, and administering authorities[27] and required managers to send a full breakdown of implicit and explicit costs in a standardised format. But the code only applied to listed asset classes, and excluded alternative and other opaque investment structures.[28]

Looking at the Lothian Group submission, it suggests that under-reported SLGPS costs are c£70–80m per annum. In our view, this number is likely to be a conservative estimate of under-reporting. This is due to the lack of granularity in the data that is collected particularly in relation to alternative investments such a private equity or hedge funds. There are reasonable exposures to these assets in the SLGPS and they are expensive vehicles with complex and opaque fees, and this issue will more problematic if such investments are held within a fund-of-funds structure.

Closet indexation

[26] https://www.professionalpensions.com/professional-pensions/analysis/3010860/how-west-midlands-cut-costs-by-millions-of-pounds-through-transparency

[27] http://www.lgpsboard.org/images/CoT/Code_of_Transparency_20190306_v_1_5.pdf

[28] *Ibid*

Closet indexation by actively managed funds is an additional area where SLGPS funds may face hidden costs. Closet indexation occurs where a fund is marketed and priced as an actively managed fund but largely follows the benchmark index. This practice has been found to be widespread globally, and there is evidence that in the UK market, domestic equity funds specifically are closet indexers.[29]

Closet indexing undercuts the value proposition of active fund managers who justify their fees by their ability to generate superior returns and beat the benchmark index after all the costs and fees of fund management have been incurred. As active managers are more expensive than passive managers who aim to track the benchmark, albeit with some error, it is really a debate about high-cost versus low-cost investing.

Closet indexation is detrimental to investors, as the limited active positions in a closet indexing fund means that it is more likely to underperform after fees.[30] Consequently, the issue of closet indexation has caught the attention of the Financial Conduct Authority (FCA).[31] This again comes back to an issue of transparency around is being charged for asset management. For trustees such activities are opaque, as the fees being charged, and the underlying investment style being marketed, are simply not aligned. Moreover, in such a setting, trustees could have achieved the same outcome at a much lower cost.

Trustee knowledge and understanding

Another way to assess how much cost and fee transparency exists in the market is to examine how familiar trustees are with costs and fees. If cost transparency is common for both explicit and implicit costs and fees, then users of this information should be familiar with both. Recent evidence however has highlighted that trustees have a good understanding of the explicit costs of fund management such as Total Expense Ratio but are unfamiliar with many of the indirect and implicit costs.[32]

The research suggests that trustees of even large schemes were unfamiliar with the implicit costs of fund management. As Figure 1 below shows, trustees were not really aware of relatively common activities such as securities lending and common costs such as market impact. It is therefore not unreasonable to assume that many of these costs and fees are not transparent to trustees. Moreover, the analysis of trustees showed that the awareness of the implicit costs worsened as scheme size fell.

Figure 1: Trustee familiarity with fund management costs and fees[33]

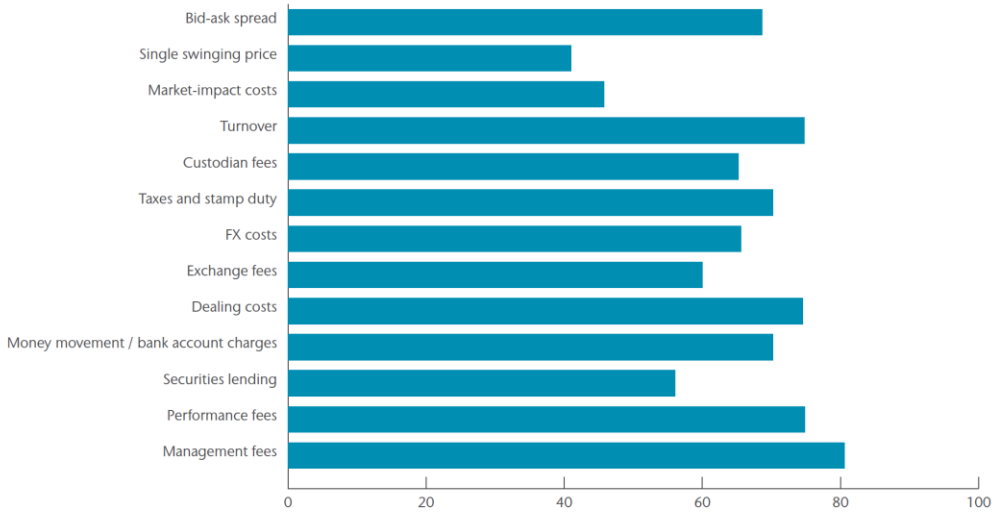
[29] Cremers, K. J. M. A. Martijn, P. M. Ferreira, and L. Starks. Indexing and Active Fund Management: International Evidence, Journal of Financial Economics Vol. 120, 3, 539-560, 2016.

[30] Petajisto, A. Active Share and Mutual Fund Performance, Financial Analysts Journal Vol. 69, 4, 73-93, 2013.

[31] https://www.fca.org.uk/firms/authorised-and-recognised-funds/closet-trackers

[32] Costs, Fees and Trustee Decision-Making, Aon Hewitt, 2017.

[33] Source: Figure 7a, Costs, Fees and Trustee Decision-Making, Aon Hewitt, 2017.



The Asset Management Market Review

In November 2015, the FCA commenced the Asset Management Market Review. This investigation into competition in the asset management industry included both retail and institutional investment sectors and concluded that the sector is not competitive; there is weak price competition; there is a lack of transparency and consistency around the costs and fees that are disclosed and charged; and the performance both active and passive funds, after taking costs and fees into account, underperformed.

For institutional investment, the interim report found evidence that of weak price competition in several areas.[34] There is low competition in active equity investments and firms in this sector do not compete on price.[35] For institutional investors, the prices of segregated mandates tend to fall as the size of the mandate increases so larger funds incur relatively lower costs.

The findings of the report showed substantial variation in performance. This variation was both across asset classes and within a specific asset class. Further, for both retail and institutional investors, on average, both actively managed and passively managed funds did not outperform their benchmarks after the costs of management.

Finally, in the proposed remedies for institutional investors, there was a recommendation that there was a need for a standardised template of costs and fees. While the report acknowledged that there were templates in existence such as the IA Code or the LGPS Transparency Code, these were not aligned, and that other work such as that of the Transparency Taskforce showed that there was a much greater detail on costs that could be realised. To achieve greater detail and standardisation, a group from across the industry as well as wider stakeholders, with an independent chairperson, was to be convened. The aim of the group was to create consistent and standardised disclosures of costs and charges that are borne by institutional investors.

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[34] https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf

[35] In the conclusions of the FCA, this lack of competition around price was most acute in retail funds. However, this does not imply there is adequate competition in the institutional market, as this was an area of significant concern, as exemplified by the recommendation to establish what became the Institutional Disclosure Working Group.

The Institutional Disclosure Working Group

In addressing one of its key recommendations, the FCA convened the Institutional Disclosure Working Group (IDWG). The terms of reference for the group was to gain agreement on cost and fee disclosure templates for asset management services provided to institutional investors.[36] As well as representatives from asset management firms, the Group included academics, investment consultants, and other intermediaries. There were also representatives from the Department for Work and Pensions, the Organisation for Economic Co-Operation and Development, the Trades Union Congress, and the CFA Institute, all of whom were independent observers. As well as the independent chair, Chris Sier, one of the deputy chairs was Jeff Houston of the Local Government Association.

The remit of the group was not just to look at equities but to also fixed income, and alternatives such as private equity, property, etc. and arrive at a standardized cost disclosure template.

The final recommendations of the group were an agreed standardised account-level template covering most product types. This captures data from providers for standard assets such as equities and bonds in one place. In addition, there are three other templates for, private equity, physical assets such as property, and custody. This data is aggregated into a user template that summarises data from an account-level template. Institutional investors can therefore easily see key data from their providers, as well as easily segment data along dimensions such as asset class or manager[37]. The FCA welcomed the findings of the Group and has implemented its recommendations.

Costs and fees post-IDWG

The recommendations of the IDWG are now being implemented. Two key recommendations are first, that a new group to curate and evolve the disclosure templates should be created and second, there should be no regulation at this point that compels disclosure, rather a market-based solution should emerge if possible.

In September 2018, in conjunction with the Pension and Lifetime Savings Association, the Cost Transparency Initiative commenced, and this group will conduct testing and curate the templates going forward.[38] In February 2018, the Advisory Board to the LGPS in England and Wales agreed that it would adopt the IDWG templates and replace the templates that were being used as part of the LGPS Advisory Board's voluntary Code of Transparency.[39]

The rationale for this switch is consistency in reporting across institutional investment including the LGPS. It will lead to greater cost disclosure for alternative asset classes that previously could not satisfy the LGPS Advisory Board's voluntary Code of Transparency and were therefore excluded. It will also provide the ability to drill down into the detail of the account templates to understand costs and fees at a granular level if needed. Consequently, asset managers that had signed up to the original code will transition to the new disclosure

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[36] https://www.fca.org.uk/publication/minutes/idwg-terms-of-reference.pdf

[37] https://www.fca.org.uk/publication/documents/summary-idwg-recommendations.pdf

[38] https://www.plsa.co.uk/Policy-and-Research-Investment-Cost-Transparency-Initiative

[39] http://www.room151.co.uk/blogs/jeff-houston-lgps-and-investment-cost-transparency/

template and all new signatories will have to follow the IDWG templates, thereby achieving greater fee transparency in the LGPS.[40]

Key Issue: Competition in investment management for LGPS funds

To what degree do LGPS funds benefit from competition for institutional investment management?

The Pensions Institute's review of material relating competition in the UK asset management sector suggests it is not a fully competitive market neither in its retail nor institutional segments. As such the SLGPS cannot place a high degree of reliance on price competition to help control investment costs in the scheme.

FCA evidence

One of the main sources of evidence relating to competition in the asset management market in the UK is the Asset Management Market Study of the Financial Conduct Authority (FCA).[41] This is a competition investigation in the same way as the Competition and Markets Authority investigates competition in other industries. The fact that an investigation occurred, at a very basic level, suggests there are significant concerns about competition.

The conclusions of the Asset Management Market Study were wide-ranging and covered both retail and institutional investment. Below is a verbatim statement from the study in relation to price competition in asset management:

"*We **find weak price competition in a number of areas of the asset management industry.** Firms do not typically compete on price, particularly for retail active asset management services. We carried out additional work on the pricing of segregated mandates which are typically sold to larger institutional investors. This showed that prices tend to fall as the size of the mandate increases. These lower prices do not seem to be available for equivalently sized retail funds*."[42]

Some submissions to the SLGPS consultation have interpreted this finding to suggest that there is a good level of competition in institutional investment, and specifically in the scheme, as the funds of the SLGPS can be considered large funds. However, what this statement says is that asset managers do not typically compete on price, and where this is most acute, is in actively managed retail funds. This statement does not say is there is no issue of price competition in institutional investment.

The FCA's study raises several different issues regarding institutional investment, and it is worth noting that pension funds were the major focus of the institutional segment of the study.

1. It suggests there is weak price competition in UK asset management as a whole, including the institutional investment sector.

2. It also says that prices for segregated mandates fall as mandate size increases, and so larger funds get better pricing. Analysis in this paper suggests that if the SLGPS

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[40] *Ibid*.

[41] https://www.fca.org.uk/publications/market-studies/asset-management-market-study

[42] Final Report of the Asset Management Market Study, p. 4. Bold highlight is in the original text and repeated here for consistency.

were to pool assets, it would be a large fund, but even this pooled fund would not come close to the largest funds in the UK or globally.[43] Moreover, in the context of the SLGPS, most of the assets under management are in the Lothian and Strathclyde funds, and so the other 9 funds are arguably relatively small. Across the SLGPS, many of the smaller funds may not therefore be achieving the benefits that accrue to the larger funds.The statement applies to segregated mandates so it is therefore an open question across the SLGPS as to the extent that competitive pricing exists, as this will in part depend on what proportion of SLGPS assets are in segregated vehicles and what proportion are in pooled vehicles.

3. The submission of the Lothian Group suggests that more than 70% of the scheme's assets are managed by 10 asset managers while under 50% are managed by two asset managers. While this is not an indication of a lack of competition per se, it is a fact that needs some careful consideration and justification in the context of the overall SLGPS.

4. In the FCA study, the average profit of the asset management industry was 36%. Moreover, the submission from the Lothian Group estimated an average profit margins for four listed asset managers in the top 10 SLGPS external managers of approximately 46%, which equates to somewhere between £60–95m in profits paid to the asset management industry by the SLGPS.

Competitive pricing and competitive markets

In economics, standard theory predicts that where supply and demand meet then an equilibrium price is achieved, and that if there are shifts in prices, then the quantity demanded of a specific good or service changes in response. However, there is evidence that this transparent and competitive pricing does not exist in all markets, and so in some markets, the equilibrium price is 'shrouded'. Gabaix and Laibson (2006) argue that indirect costs, such as add-on prices can be 'shrouded' in markets where consumers do not anticipate the total cost when purchasing the primary product[44]. The consequence of this is that rather than supply and demand clearing at an equilibrium price, there is an excess demand i.e. too much of a good or service is consumed.

In addition, there is widespread evidence that buyers in certain markets systematically misunderstand product features e.g. add-ons, and this allows firms to charge high prices once they have an established relationship with the consumer (DellaVigna and Malmendier 2004).[45] Moreover, these unanticipated higher prices can persist even in settings where competition in the market is high. The consequence of this is that regulatory intervention may be required to improve consumer outcomes.[46]

In looking at competition in asset management in the UK, one of the key recommendations to address weak price competition on the institutional side was the need for there to be standardised granular cost and fee data. To this end, the FCA set up the Institutional Disclosure Working Group.[47] Given growing the evidence on the opaque pricing of asset

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[43] See section *Key Issue: Scale benefits and the SLGPS*

[44] Gabaix, X., & Laibson, D. (2006). Shrouded Attributes, Consumer Myopia, and Information Suppression in Competitive Markets. Quarterly Journal of Economics, 121 (2), 505-540.

[45] DellaVigna, S., & Malmendier, U. (2004). Contract Design and Self-Control: Theory and Evidence. Quarterly Journal of Economics, 119 (2), 353-402.

[46] Heidhues, P., Köszegi, B., & Murooka, T. (2012). Deception and Consumer Protection in Competitive Markets. Konkurrensverket.

[47] See section *Key Issue: Scale benefits and the SLGPS* for more detail.

management, and the need for better and more consistent fee disclosure, the consumption of the asset management industry by pension funds is one where there may well be excess demand for the services provided, as the 'true' cost of asset management is shrouded.

Investment consultants and trustee decision-making

One important aspect of the environment in which trustees operate is their use of investment consultants. Investment consultants have been integral to the trustee decision-making process since the Myners Report (2001)[48] and were a specific area of focus in the Asset Management Market Study.

Investment consultants are a key intermediary in supporting trustee decision-making and are often integral to manager selection through providing ratings for specific managers. In looking at the findings of the Asset Management Market Study, investment consultants' advice on asset allocation and investment strategy was found to be significantly more influential in terms of outcomes than the advice on manager selection. That said, many institutional investors were found to struggle with monitoring and performance assessment in relation to the advice received.

The evidence from the Asset Management Market Study also showed that while asset management fees were considered as part of investment consultant ratings, this was typically not a major component of the overall ranking a fund manager received. Moreover, the final report the of FCA concluded that it was clear that different investment consulting firms placed a differential emphasis on fees in the rating process.

As well as an inconsistent emphasis on fees, investment consultants were not able to identify managers that offer better returns to investors[49]. In looking at consultant recommendations, Jenkinson et al (2017) show that funds that are on investment consultant buy-lists underperform.[50] This is due to the increase in fund flows from being on the buy-list and the inevitable diseconomies of scale[51] that occur in mutual funds. Overall, given the complex relationship between trustees and investment consultants, it is not clear to what extent there is price competition in asset management through this route, nor what performance is likely to accrue to pension funds in such a setting.

Long-termism in markets

The final issue with respect to competition in the asset management industry is to examine the impact of short-termism. As the Kay Review sets out clearly:[52]

"*Competition between asset managers to outperform each other by anticipating the changing whims of market sentiment – Keynes' beauty contest – can add nothing, in aggregate, to the value of companies (just as the contest Keynes describes does not make any of the faces portrayed more beautiful) – and hence nothing to the overall returns to savers*."

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[48] Myners Review: Institutional Investment in the UK (2001)

[49] However, the manager selection process ensures that asset managers meet minimum quality standards and reduces operational risk for investors.

[50] Jenkinson, T., Jones, H., and Martinez, J.V., 'Picking Winners? Investment Consultants' Recommendations of Fund Managers' in Journal of Finance, 71(5) (2017), 2333-370

[51] See section *Key Issue: Scale benefits and the SLGPS* for more detail.

[52] The Kay review of UK equity markets and long-term decision making, Final Report, July 2012.

The conclusion of this statement is twofold. First, that competition between asset managers is competition to gain “alpha” – building an investment portfolio that offers superior returns to a comparable benchmark – and in aggregate this is a zero-sum game where the presence of investors who earn superior returns mean there must be investors who earn inferior returns. This is particularly true over the long-run i.e. in pension funds. Second, in such a setting, a true understanding of the cost of asset management is essential, as small changes in the cost of investment will significantly change investment performance outcomes.

In looking at the incentives in asset management, the Kay Review concludes that:

“The appointment and monitoring of active asset managers is too often based on short-term relative performance. The shorter the timescale for judging asset manager performance, and the slower market prices are to respond to changes in the fundamental value of the company’s securities, the greater the incentive for the asset manager to focus on the behaviour of other market participants rather than on understanding the underlying value of the business.”[53]

Overall, the investment management industry for pension fund investment has misaligned incentives and is a market where competition is arguably not based on ability in the long run, but short-run relative performance.

[53] *Ibid*.

Key Issue: Scale benefits and the SLGPS
How reasonable is it to expect scale benefits for SLGPS funds?

Based on our review the Pensions Institute believes that it is reasonable to expect that larger SLGPS funds benefit from economies of scale in the cost of investing. In the UK, larger funds are likely to have greater buying power and command lower costs and internationally, large pension funds tend to have both lower costs and generate higher returns. Although pension funds can become subject to diseconomies of scale, SLGPS funds in aggregate are small on an internationals scale, and are therefore unlikely to reach the threshold where these dis-benefits would apply.

There is a limited body of research that looks at LGPS funds in the UK and using this evidence alone has made it difficult to draw firm conclusions on the degree to which SLGPS could expect to benefit from scale in the management of investment costs. Existing studies can be used to argue for or against scale benefits as responses to the consultation note. Therefore this review includes international evidence relating to scale in pensions funds.

Economies and diseconomies of scale

Economies of scale is a foundational concept in economics, and it applies across a range of businesses and contexts, including in pension funds and asset management. Economies of scale benefits include operational efficiency, so the cost per unit of production is cheaper; buying power to negotiate lower costs on inputs; specialization so that expertise is developed or hired in specific areas; and improved risk-bearing. That said, there are limits to economies of scale, and so if a business or organization becomes too large, then these benefits start to decrease. For example, the cost per unit of production starts to increase as operational efficiency declines.

In the context of pension funds, it is useful to illustrate how diseconomies of scale can occur. This is a slightly more nuanced exercise than the traditional examination of the diseconomies of scale in a firm where inefficiencies occur due to issues of control and informational asymmetry. In the traditional firm, scale can, for example, decrease performance through increasing the costs associated with using soft information inside larger hierarchies.[54]

For pension funds, and this is true of the SLGPS, a significant amount of asset management is outsourced. The natural starting point to understand where diseconomies can occur is to examine diseconomies in the mutual fund literature,[55] and evidence of diminishing returns to scale in mutual funds has been found in numerous studies.[56] Part of this reduction in returns is because fund inflows simply scale up the current investment strategy of the fund rather than leading to other investment strategies.[57] Another aspect of the diseconomies effect is driven by market impacts driven by larger transaction sizes.[58]

The first question that must be asked, is therefore, what is large in pension fund terms? If total SLGPS assets were to exceed this then it could be argued that diseconomies of scale could occur.

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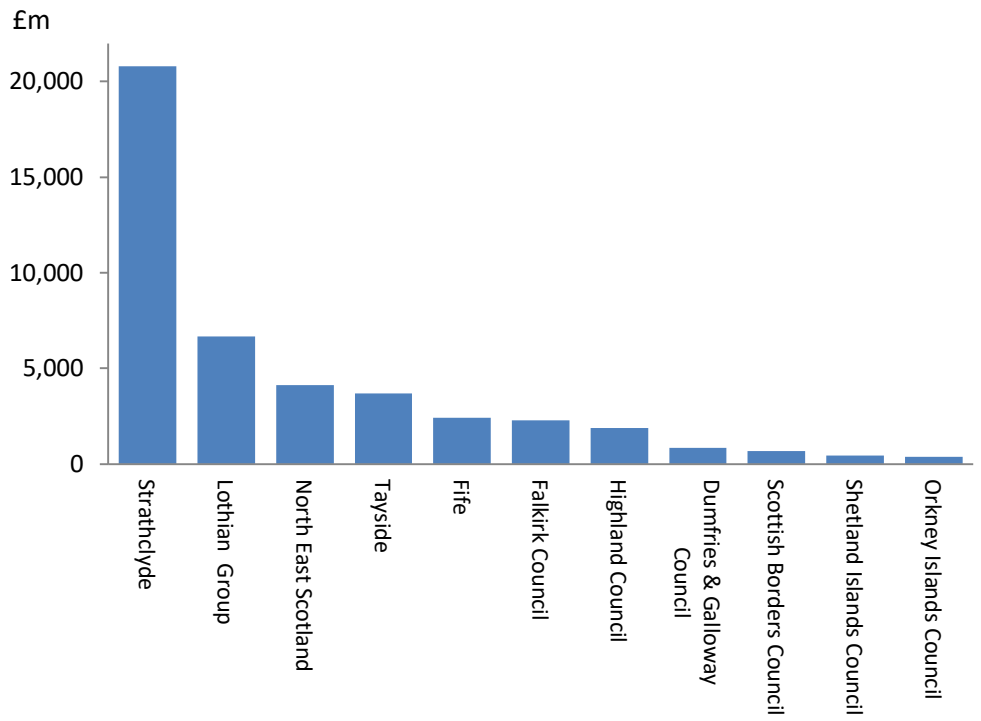
[54] Stein, J. C., (2002), Information Production and Capital Allocation: Decentralized versus Hierarchical Firms, Journal of Finance, Volume 57, No. 5, 1891-1921.
[55] Dyck, A. L. and Pomorski, (2011), Is Bigger Better? Size and Performance in Pension Plan Management, Rotman School of Management Working Paper No. 1690724
[56] Chen, J. S., G. Harrison, M-H. Hong, and J. D. Kubik, (2004), Does Fund Size Erode Mutual Fund Performance? The Role of Liquidity and Organization, American Economic Review, Volume 95, No. 5, 1276-1302.
[57] Pollet, J. M. and M. Wilson, (2008), How Does Size Affect Mutual Fund Behaviour? Journal of Finance, Volume 63, No. 6, 2941-2969.
[58] Edelen, R. M., R. Evans, and G.B. Kadlec, (2007), Scale Effects in Mutual Fund Performance: The Role of Trading Costs, Working Paper, University of California, Davis.

Figure 1: Scottish LGPS funds by assets under management, 31 March 2018[59]



The SLGPS is composed of 11 individual funds with assets totalling around £42bn and liabilities to members of £55bn.[60] Each fund serves a different group of employer organisations, the largest fund is Strathclyde with £19.7bn in assets and 210,000 members; Orkney Islands is the smallest, with assets of £335m and 3,663 members.[61] Figure 1 above shows a bar chart of the 11 funds by assets under management (AUM). Below, Figure 2 shows the top 10 pension funds globally by assets under management for the year ending 2016.

Figure 2 Top 10 global pension funds end 2016 by assets under management[62]

Rank	Name	Country	AUM US$ m
1	Government Pension Investment	Japan	$1,237,636
2	Government Pension Fund	Norway	$893,088
3	Federal Retirement Thrift	U.S.	$485,575
4	National Pension South	Korea	$462,161
5	ABP	Netherlands	$404,310
6	National Social Security	China	$348,662
7	California Public Employees	U.S.	$306,633
8	Canada Pension	Canada	$235,790

[59] Source: Audit Scotland; fund annual reports

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

[61] All figures dated 31 March 2017

[62] Source: Pensions & Investments / Willis Towers Watson 300 analysis

9	Central Provident Fund	Singapore	$227,102
10	PFZW	Netherlands	$196,461

What is very clear from comparing Figure 1 and Figure 2, is that the SLGPS even when pooled would be orders of magnitude smaller than the largest funds globally. Moreover, in the same survey, The BT Pension Scheme and the Universities Superannuation Scheme (USS) only rank 56 and 59 respectively. Consequently, if the SLPGS were to pool it would still be significantly smaller than either the BT pension fund (£49.1bn)[63] and USS (£63bn). Overall, the pooling of the SLGPS is not of a scale where diseconomies of scale are likely to occur, and so it is reasonable to assume that there are scale benefits that would accrue.

Additional evidence on the source of the returns to scale can show that the largest pension funds outperform smaller funds by 45-50 basis points per annum on a risk-adjusted basis. Moreover, between one-third and one-half of these gains arise from cost savings that are attributable to internal management, where costs are, on average, at least three times lower than under external management.[64]

Scale in pension funds and the costs of investment

There are several ways of examining the issue of examine if the costs of asset management and administration are subject to the benefits of scale and larger funds are cheaper to run.

UK evidence suggests that larger funds have better able to procure outsourced – external – asset management on favourable terms. The Asset Management Market Review of the Financial Conduct Authority (FCA)[65] examined the level of competition within both the retail and institutional investment sectors. One key insight in relation to scale is that, "*On the institutional side, there are a large number of small pension schemes and trustees which vary in how effective they are at negotiating price.*"[66] In the UK, larger pension funds are therefore, on average, better able to drive cost efficiencies in the procurement of outsourced asset management services.

International studies of pension funds show that larger funds tend to have lower costs. One example is the Swedish Premier Pension System. The strategic plan for the scheme is to reduce total costs over a thirty-year period from 0.71% to 0.17%. As Table 1 below shows, there are cost savings in both administration and in the costs of asset management from 0.71% to 0.33% in 2017.

Table 1: Costs in the Swedish Premier Pension System (percentage points)[67]

	2002	2005	2008	2011	2014	2017	2020	Target
Administration costs (% AUM)	0.30	0.23	0.18	0.15	0.12	0.08	0.04	0.05
Fund management costs (% AUM)	0.41	0.36	0.32	0.29	0.27	0.25	0.24	0.12

[63] Source: BT 2018 Annual Report
[64] Dyck, A. L. and Pomorski, (2011), Is Bigger Better? Size and Performance in Pension Plan Management, Rotman School of Management Working Paper No. 1690724
[65] https://www.fca.org.uk/publications/market-studies/asset-management-market-study
[66] https://www.fca.org.uk/publication/market-studies/ms15-2-2-interim-report.pdf
[67] Source: Sweden's New Pension System, Swedish National Social Insurance Board

Total fund costs (% AUM)	0.71	0.59	0.50	0.44	0.39	0.33	0.28	0.17

One aspect of being able to achieve cost efficiencies comes from the ability to perform asset management in-house, rather than using outsourced asset management. The is plentiful evidence that outsourced services in the public service sector are more expensive; the Private Finance Initiative programme provides leading examples.[68]

Regarding in-house against outsourced asset management, comparing the SLGPS to the University Superannuation Scheme (USS), the investment fees of USS are 34% lower (0.31% of investments, compared to 0.47% for the SLGPS)[69].This cost differential is largely attributable to the fact that c75% of USS assets are managed internally (vs c10% for SLGPS). If the SLGPS could achieve the USS expense ratio of 0.31%, then fee savings could be £65m per annum assuming the current cost disclosure mechanisms of the SLGPS are capturing the 'true' cost of asset management. It is also worth noting that more expensive investments are typically illiquid, so savings from these allocations could take time to materialise. However, a separate analysis (based on Lothian's internal team expense ratio of 0.09%) suggests that material savings of £65m per annum would be possible from in-house management of the SLGPS liquid assets alone.

As well as the discussions around the cost of in-house vs outsourced asset management, there is a question of incentives. In the original evidence provided to the consultation on scale in pension funds, the case of the Ontario Municipal Employers Retirement Scheme (OMERS) was presented. The structure of OMERS is the result of a strategy to build in-house teams across all activities of the fund, including both public and private investments. In-house teams, therefore, originate, execute, and directly manage most scheme assets on behalf of members. This enables coordination across investment platforms to manage costs. More importantly, this give absolute clarity to the investment objectives of the fund, as these in-house teams are focussed solely on the delivery of the long-run objective of the fund i.e. to pay pensions.

One final area of disagreement is whether the pooling of the LGPS in England and Wales is delivering cost efficiencies. As with debates on various analyses that have been undertaken for the SLGPS[70] the initial evidence from the LGPS pools in England and Wales provides some insight but needs careful consideration as it is presented at a point in time when funds have not fully pooled and others have only recently been authorised by the FCA.[71] A recent study[72] found ACCESS, who has already contractually pooled circa £11bn of passive assets under a single commercial relationship with UBS, is expected to generate £5m cost savings per annum. The Local Pensions Partnership has generated £7.5m per annum in fee savings for global equities alone.[73]

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[68] https://www.theguardian.com/public-leaders-network/blog/2012/apr/11/public-private-partnerships-the-record-isnt-great

[69] The USS expense ratio of 0.31% is based on independent third-party benchmarks and not the accounts of the fund.

[70] See discussions on the analysis to the APB, Deloitte and Mercer papers in the submissions to the consultation.

[71] For example, the Brunel Pension Partnership only received FCA authorisation as a MiFID full-scope investment firm in March 2018.

[72] https://www.professionalpensions.com/professional-pensions/feature/3029061/where-are-the-lgps-pools-three-years-on

[73] The Local Pensions Partnership has already saved more than set out in its business plan as the initial estimate was £30m net savings in investment management fees over five years.

Governance and democratic accountability

Two further issues that are raised with respect to pooling or merging are the loss of local accountability and the ability of funds to engage with issues that are locally important e.g. Environment, Social, and Governance (ESG) issues.

For the first, whether local accountability is possible, this simply down to whether the governance structure chosen enables this. There are many examples of governance structures that allow for democratic accountability in scheme governance over much more diverse populations and regions. One notable international example is the CERN pension fund in Geneva. Here there is an executive board that run the scheme, but given the international nature of CERN, there is a supervisory board that has representation for employees, as well as sponsoring member states to ensure that the running of the scheme and its costs has democratic accountability[74].

The second issue of ESG and holding firms to account is more challenging. In the submissions to the consultation there is a sense that ownership and voting are directly linked in the current structures. However, the reality of ownership in the UK is one that is opaque, and the link between issuers and asset owners is one that often does not allow for voting to take place in a direct way. Ownership is usually through a complex chain of intermediaries such as custodian banks, proxy voting agents, and fund managers, with no visibility given to asset owners.[75] For larger pension funds there are fewer structural barriers to exercising shareholder rights. However, the barriers that exist for smaller funds are considerable as not all investment managers allow for split voting in pooled funds and dissuade smaller funds from exercising "voice".[76] The proportion of outsourced investment management and the number of smaller, funds in the SLPGS means that the level of influence on investee firms is unlikely to exist in the way in which most trustees expect.

[74] http://pensionfund.cern.ch/en/social-security-for-personnel/organisation-of-the-fund/composition-of-the-governing-board
[75] See for example, Exploring the Intermediated Shareholding Model, the Department of Business Innovation and Skills (2016).
[76] *Ibid*

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Report on the Consultation on the

Review of the Structure of the Scottish Local Government Pension Fund

Part 2: Analysis of Responses

Carried out by the Pensions Institute

on behalf of the Scottish Local Government Pension Scheme Advisory Board

David Blake

Matthew Roy

April 2019

Contents

About the Scheme Advisory Board

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

About the Pensions Institute

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

David Blake

Professor David Blake is the Director of the Pensions Institute and Professor of Pensions Economics at Cass Business School. He was educated at the London School of Economics, gaining a PhD in Financial Economics in 1986. David previously worked at the LSE, the London Business School and Birkbeck College before joining Cass Business School (part of City, University of London) in 2004 as a professor in the Finance Faculty. He set up the Pensions Institute in 1996.

Matthew Roy

A Fellow of the Pensions Institute, Matthew has worked in finance, policy and strategy roles in Europe and Asia Pacific. Matthew is New Zealander by birth, holding an M.Comm (1st Class Hons.) from the University of Canterbury. Beginning his career as a policy adviser he has worked in economics, securities marketing and as a journalist to international finance publications. Since moving to Scotland in 2011, he has advised global financial organisations on marketing strategy and participated in third-sector community energy projects and regeneration bodies.

Introduction to Part II

This report summarises the responses of participants in the 2018 consultation carried out into the structure of the Scottish Local Government Pension Fund (SLGPS) by the Scheme Advisory Board (SAB).

This is Part II of a two part report. Part I contains summary conclusions and key issues raised by the consultation.

Part II: Reporting

The responses are reported and analysed against the consultation criteria. Additional comments are included.

3. **Findings:** Detailed findings are presented based on the analysis of responses.

4. **Analysis of respondents**: Reviews the number and type of respondents and their stated preference for the four options presented in the consultation.

5. **Arguments for and against the four options**: Presents the views of the respondents on each option.

6. **Additional comments:** Includes additional arguments made by the consultees relating to evaluation criteria and socially responsible investing

3. Findings

Based on the analysis of responses, the conclusions of each option are summarised against the consultation criteria of cost of investing, governance, operating risks and infrastructure. Respondents reasons for supporting or opposing each option are summarised. The analysis is based on qualitative assessments of the arguments made by respondents rather than the quantity of respondents making a particular argument.

Option 1: Retain the current structure with 11 funds

Based on the analysis of responses, the following conclusions are drawn on respondents' views towards the first option – maintain the status quo with 11 funds.

a) Cost of investing

Reporting and access to investment costs

While respondents said they had good access to cost information from administering authorities, on balance, the comments suggest the SLGPS could do a better job of creating transparent and comparable data on investment costs. Recent reforms such as the LGPS Code of Transparency and CIPFA guidance were said to have improved transparency. But some said reported costs were still insufficiently granular, not comparable between funds and that producing benchmark-able costs was a resource intensive exercise.

Management of investment costs

There is no consensus on how well the scheme manages investment costs. Responses indicate that a lack of comparability hinders judgements on what reported expenses show about the state of cost management. Although external management is competitively purchased, responses suggest external fund managers are still able to command significant profits from scheme funds. While responses indicate that funds benefit from the scheme's public sector administrative controls, they also suggest larger funds have access to additional options to control costs such as internal management.

Interpretations of data, competition issues and administrative controls were the key points of reference in discussing how well the scheme deals with investment management costs.

Interpretations of data: Lack of comparability likely hinders judgements on what reported expenses show about the state of investment cost management in the SLGPS.

Some responses suggested costs were low and stable or; additional measures, such as net returns, funding levels and contribution rates, should be taken into account and these presented a picture of good scheme performance.

For instance, later in this report, Audit Scotland data on investment management costs in 2017-18 is presented by Tayside Pension Fund as evidence that scale benefits are present. Others said that investment costs prepared under current CIPFA guidelines did not show the whole picture and the SLGPS as a whole underreported costs as a result. The Lothian Group[1] estimated this at £70–80m annually.

[1] Joint response by the Lothian Pension Fund executive, Lothian Pensions Board and Pensions Committee of City of Edinburgh

The Pensions Institute's review in Part I of this report suggests that the fees disclosed by asset managers in the UK are not transparent and therefore the SLGPS cannot rely on the data currently reported under the system to assess how well the scheme manages investment costs or make comparisons between funds.[2] Costs are likely under-reported. However, this situation is likely to improve if the scheme and funds adopt the Institutional Disclosure Working Group templates.

Competition issues: Although the UK asset management market may have become more competitive, evidence presented suggested external fund managers are still able to command significant operating profit margins from scheme funds.

Some respondents reported increasing competition in asset management with fees being passed on to the SLGPS since reforms to local government pension system in England and Wales. The FCA's Asset Management Market report was evidence of competition, because LGPS funds should be viewed as large investors, while the report showed poor price competition for retail investors.

Other respondents said the same report showed the market was not competitive, because the findings of weak price competition applied to LGPS funds. Data was presented that suggested SLGPS funds are paying higher prices for external management than if the market was fully competitive.

Analysis by the Lothian Group suggested that if the FCA findings applied to funds in the scheme and assuming an average external manager profit margin of between 30% - 45%, then then SLGPS was paying £60–95m in profits to the asset management industry annually. Lothian Group presented analysis suggesting external management of SLGPS assets was concentrated with Legal & General and Baillie Gifford managing half of scheme externally managed assets with 10 managers accounting for 70% of assets.

The Pensions Institute's review in Part I of this report of material relating competition in the UK asset management sector suggests it is not a fully competitive market neither in its retail nor institutional segments.[3] As such the SLGPS cannot place a high degree of reliance on price competition to help control investment costs in the scheme.

Administrative controls: The SLGPS benefits from significant institutional arrangements to manage investment costs, responses indicate, but larger funds likely have access to additional measures including the option to manage funds internally.

Respondents said the scheme benefits from competitive public procurement, public reporting disciplines and active contract management. But in principle at least, many response said larger funds had greater market power, more resources to control costs and the option to lower costs by managing funds in house.

The Lothian Group presented data showing an investment expense ratio of 0.09% for the funds internally managed assets compared with 0.47%, for other scheme funds although this

[2] See the report section: *Key Issue: Transparency of investment costs*

[3] See the report section: *Key Issue: Competition in investment management for LGPS funds*

is not on a like-for-like basis as 32% of the fund's assets are externally managed and these assets are likely to be in more expensive specialist asset classes.

Improving measurement and management of costs

Respondents generally believed that measurement and management of costs in the SLGPS could be improved, ranging from allowing existing and new measures under development to bed in, to suggesting new transparency measures or administrative controls.

Leveraging existing activities Respondents said transparency of investment costs could be improved by promoting or making it mandatory to adhere to a range of existing regulations and guidelines. Mandatory transparency measures included CIPFA guidelines, the Code of Transparency, MiFID II rules as well as data collection templates from the FCA's Institutional Working Group and those being developed for England and Wales LGPS. Some responses suggest the SAB should play an active role, by publishing its cost transparency database currently under development and benchmarking costs against funds both inside and outside the LGPS.

Administrative measures: Respondents proposed additional administrative measures including making FCA templates into mandatory procurement requirements, improving contract service reporting, moving investment management in house and providing additional resources to funds.

Reforms to CIPFA guidelines: Reporting standards should be amended to ensure full disclosure of funds investment management costs including show reported expenses and investment performance net and gross of fees.

b) Governance

Reporting and access to governance information

Respondents believed they had good access to information on how the scheme was governed. Some multi-fund employers said they could not participate in governance fully as they didn't have sufficient resources to process the information from multiple funds.

Quality of SLGPS governance

Respondents generally believed the SLGPS was good at adhering to the governance requirements presented to it. But the structure of the scheme itself gave rise to governance problems for some respondents including the presence of multiple different governance arrangements and administration by local authorities.

Compliance: Respondents cited compliance with existing arrangements; consultation by funds in governance matters; Audit Scotland audits; the outcome of the 2016 KPMG review; and training measures as evidence that the scheme was well governed.

Consistency: Responses weighed the bespoke implementation of governance by each fund. Some said these arrangements were necessary to ensure local participation, that findings earlier of skill issues had been resolved and that governance arrangements mitigated any potential conflict in the dual role of administering authorities as pension fund managers and employer participants.

Others said this approach created inefficiencies, led to skill gaps, caused overreliance on advisors and made the system's performance difficult to evaluate. Because each fund had

its own approach to governance, multi-fund employers said they found it difficult to manage their involvement with multiple funds.

Dual role of administering authorities: Administration by local authorities was said to give an outsize role in governance to administering authorities, cause skills issues due to the electoral turnover of councillor members and lead to unresolved fiduciary conflicts. Respondents presented evidence of conflicts of duties caused by council policies that affected resourcing of administering authorities and the treatment of cessation issues for charity admitted bodies.

Improving governance

Suggestions to improve governance focused on making the current system work better through training and transparency; by overhauling pension boards and committees; or structural adjustments that would lead to financial independence for pension funds and a single fund for multi-fund employers.

Skills and training: Respondents proposed giving time to carry out existing measures relating skills, including the recommendations of the 2016 KPMG reports. Additional training measures were proposed including ongoing professional development and mandatory training for pension board and committee members: trustee toolkits from the FCA and The Pensions Regulator were recommended.

Transparency and benchmarking: Respondents suggested governance could be improved by: ongoing monitoring of best practice; regular governance reviews; outside audits; sharing of experience between fund pensions boards; greater public sharing of fund policies; and proactive SAB measures.

Overhauling pension boards and committees: Responses suggested pension boards and committees could be given greater ability to provide oversight, including clearer roles in legislation and more independent board members. Pension Boards powers of scrutiny should be boosted through legislative clarification, mandatory representative by employers, members or independent outsiders, and potentially the ability to make decisions.

Financial independence: Respondents proposed that pension funds should become separate organisations in their own right with a distinct budget, resources and [Section 95] officer. This proposal could be informed by the review currently being undertaken by the English & Welsh LGPS on the potential separation of pension funds from administering authorities

Single fund for multi-fund employers: Responses proposed that each multi-fund employer should be offered options to consolidate their members into a single SLGPS fund.

Importance of a local connection in oversight and strategy

Respondents cited a range of benefits of local governance or alternatively asked if a local connection existed or provided evidence that a local connection was either a disadvantage or not much of an advantage.

Alignment with local membership and taxpayers: A local connection was cited as a benefit to oversight and strategy because it provided demographic accountability to taxpayers, and aligned fund strategy to member demographics and employer contributions which was said to improve fund performance. A local connection was said to encourage employer and employee participation, and improve administrative effectiveness.

Local budgets and economy: Some responses said a local connection was important because funds had a significant impact on council budgets and others said the impact on the local economy was a reason for local governance. For instance, the Shetland Islands Council Pension estimated its membership was equivalent to about 31% of the Shetland Islands population.

Absence of local connection: Responses that questioned the value of a local connection asked whether one really existed with only 11 of the 32 Scottish authorities having governance rights as administering authorities; or because strategy decisions were largely the province of the pension fund executive.

Variation in practices: A local connection was said to be a disadvantage because it led to a variation in practices, higher costs and uneven uptake of best practices such as fee transparency, ESG and infrastructure investment. Variation in fund performance was said to be un-related to geography but the result of investment strategies and market conditions.

Multi-fund employers: Multi-fund employees said that they found the division of the scheme into 11 funds to be a disadvantage because of the cost of complying with differing administrative requirements and because staff experienced differing treatment according to their fund membership. Police Scotland said its national organisation was no longer aligned with the funds it was a member of and it was at risk of being treated as a closed employer as a result. Scottish Fire and Rescue Service reported that falling membership in some smaller funds had lead it to take on a disproportionate share of liabilities.

The benefits of a local connection in governance versus the benefits of scale

Respondents offered views on determining if the benefits of a local connection outweigh the benefits of scale; whether scale was necessary for good governance; or whether scale existed in the SLGPS currently.

Local connection versus scale benefits: Some responses said that scale was unconnected to maintaining local governance or scale benefits, such as cost reductions and increased returns, could be pursued while preserving local governance. Responses also questioned whether there was evidence that scale offered benefits; or sufficient benefits to sacrifice a local connection; pooling in England and Wales was cited as failing to demonstrate scale benefits.

For instance the CIPFA response suggested that the studies used so far to evaluate the performance of the SLGPS and presence of scale benefits had insufficiently short time periods and multiple rolling time periods would be more appropriate. Results from the APG report that the four largest UK LGPS funds performed better than average should be viewed with caution as the study reviewed data over a short time horizon of 2001–09 at a period in LGPS history when investment returns were low. It said that the Mercer study also had a short time horizon of 2010–15 and indicated that there is no positive correlation between fund size and investment return. A study with longer rolling time periods would see “a very different picture of performance will emerge.”

Based on our review in Part I of this report, the Pensions Institute believes that it is reasonable to expect that larger SLGPS funds benefit from economies of scale in the cost of investing. In the UK, larger funds are likely to have greater buying power and command lower costs and internationally, large pension funds tend to have both lower costs and generate higher returns. Although pension funds can become subject to diseconomies of scale, SLGPS funds in aggregate are small on an internationals scale, and are therefore unlikely to reach the threshold where these dis-benefits would apply.[4]

Some respondents suggested the benefits of a local connection could be weighed against reductions in member and employer contributions and increases in returns if granted by scale. Although acknowledging the benefits of a local connection, SEPA suggested that an option appraisal be carried out to assess whether small and medium funds could continue to meet their statutory and regulatory obligations.

Scale, good governance and good performance: Some discussed the link between scale and good governance. These responses suggested that there was no link between the two, or that good governance was linked to good performance rather than scale.

Scale already exists in the LGPS: Respondents argued that costs and investment returns reported by the SLGPS in 2017–18 showed that funds already enjoy scale benefits; costs were unrelated to scale; and net returns were unrelated to scale. Tayside Pension Fund, and North East Scotland Pension Fund said they enjoyed some economies. Audit Scotland data on investment management costs in 2017-18 was presented by Tayside Pension Fund and cited by others as evidence that scale benefits are present. Responses acknowledge the scale of Strathclyde Pension Fund, and the fund said it enjoyed both a local connection and scale benefits with £21bn in assets but that further scale could be of detriment to its local connection.

c) Operating risks

Reporting and access to operating risk information

Most respondents generally believed they had access to information about operating risks of funds in the SLGPS and were well informed. Where respondents felt they were less well informed, it was because they were employers with insufficient resources to monitor funds, or because they were aware that smaller funds may have fewer internal resources to manage operating risks.

Ability of the SLGPS to manage operating risks

Respondents believe the SLGPS has strong controls, systems and processes but some identified concerns with the availability of skills and use of external advice. Respondents were divided on whether each fund having its own approach to operational risk management helped or hindered while significant issues with the treatment of cessation/termination liabilities for admitted bodies were raised.

Controls, systems and processes: Respondents agreed that the controls, systems and processes in the scheme contributed to good management of operating risks by the scheme.

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[4] See the report section: *Key Issue: Scale benefits and the SLGPS*

These included compliance with regulations, internal controls, a risk management culture, audits and software systems. The Lothian Group cited the establishment of a separate legal entity as beneficial for management of operating risks.

Skills and external resources: Respondents disagreed on whether all funds in the scheme had access to the skills needed to manage operating risks. Some funds could employ officers and specialists; there were concerns that smaller funds could not. Most funds made usage of external advisers and managers. This offered benefits because of the professional expertise and resources of external suppliers, or potential risks and conflicts of interest because funds were taking investment advice from the same suppliers that sold them investment management services. Collaboration with sharing internal investment resources was cited by Falkirk Council as a means to access expertise to manage operating risks.

Diversification: The bespoke approaches to operational risk management by different funds was cited as either providing diversification benefits; or as leading to inconsistences and difficulties in judging the effectiveness of risk management in the scheme.

Cessation and legacy liabilities: Robertson Trust and SCVO said that the treatment of legacy liabilities was an operational concern for the SLGPS. The respondents said charities were receiving inequitable and inconsistent assignment of liabilities by funds on cessation. This and other inconsistencies made charities wary of undertaking public sector contracts that could lead to membership of the scheme.

Improving management of operating risks

Respondents proposed standardisation and benchmarking of risk reporting; benefits simplification; improvements to people, processes and systems; and mandated consistent adoption of cessation reporting standards and liability accrual.

Standardised reporting: Respondents proposed greater standardisation and disclosure of risk register and fund performance reporting, including a framework of standards expected of the SLGPS to measure performance against. It was also proposed that SAB should collate and publish risk registers annually

Benefits simplification: Many respondents suggested simplifying benefits regulations as reducing operational risks citing the complexity involved in administering three benefit schedules (1/80th, 1/60th, 1/49th), differing discretions, 30 contribution rates, certificates of protection and aggregation rules.

People, processes and systems: Respondents suggested systematic sharing of best practice; greater training and better management of key person risks, variously for governance personnel, administrators, decision makers and members of SAB. Administering authorities could gain benchmarking information by consolidating their use of the Aquila Heywood Altair LGPS software onto the cloud.

Cessation regulations: Robertson Trust and SCVO recommended better transparency and communication for the treatment of cessations. This includes implementing the proposals made by the Institute of Chartered Accountants of Scotland in September 2017 and requiring funds to act on updated LGPS legislation in 2018.[5] Funds should provide admitted bodies with an estimated cessation valuation and explanation in line with FRS102 disclosure requirements.

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[5] Local Government Pension Scheme (Scotland) Employer Data Collection Exercise, *Revised response from ICAS to the Scottish Public Pensions Agency*, 21 September 2017. The Local Government Pension Scheme (Scotland) Regulations 2018.

d) Infrastructure

Reporting and access to information on infrastructure

Respondents believed they had good access to information on infrastructure investments in the scheme.

Ability of the SLGPS to invest in infrastructure

Responses suggested that larger funds had better, or cheaper, access to infrastructure investment. Collaboration was presented as means for smaller funds to gain access to infrastructure.

Scale: Respondents agreed that larger funds were able to access infrastructure investments as they had the resources to deal with the costs of direct investing including specialist risk, return and governance characteristics; supply-constraints and illiquidity. Smaller funds couldn't afford to directly invest and were burdened with higher fees and potentially lower returns when investing in the asset indirectly through funds-of-funds.

Cooperating: Some small and medium funds - Scottish Borders and Falkirk - has been able to directly invest in infrastructure by cooperating with the Lothian Pension Fund.

Increasing infrastructure investment in the SLGPS

Respondents agreed that supply side measures could be used to increase infrastructure investment but opposed measures on the demand side as these would conflict with the aims of the scheme and fiduciary duties.

Demand side: Many responses said the choice of individual funds to invest in infrastructure depended on the asset being appropriate to the funds' investment strategy, itself based on fiduciary duties to members and employers, and this process should not be usurped by public policy. Unite suggested that any demand side public policy measures should carry guarantee that pensions will be protected and underwritten by the Scottish Government. For some funds, fund maturities limited the appropriateness of infrastructure as investment, while the ability of finance to fund infrastructure was a problem for others.

Supply side measures: Many responses suggested improving the supply of investments that were a 'suitable proposition' for funds. This included looking at Scottish Futures Trust proposals on pooled housing infrastructure investments, or a role for government establishing investment vehicles that provided the risk-return characteristics required by funds. Direct cooperation with public bodies that might require infrastructure finance was mooted.

e) Summary of reasons for supporting and opposing option 1

The case for the status quo

In making the case for the status quo, respondents' key points of reference were the scheme's current conditions, a lack of a case for other options and the singular position of

the Strathclyde Pension Fund. These are used to describe the positions of the respondents:[6]

Scheme conditions: Many respondents said 'if it isn't broken, don't fix it'; the SLGPS is a success story and so the status quo should be preferred. Responses cited the scheme's funding level; scale; industry awards; costs; performance; quality of external fund managers; employee participation rates; and governance. A regional structure offered risk diversification and the ability of small funds to invest nimbly could be weighed against reduced access to economies of scale. Local ownership was a key ingredient in the scheme's performance, controlling costs and sustaining governance.

Case has not been made for other options: Respondents said that there was insufficient empirical evidence of the benefits of scale in investment costs or performance from the other options to justify the risks to investment performance, member participation, funding, employee contribution rates, or local conditions. This lack of evidence applied to analysis of scale benefits of funds in the scheme currently, the experience from pooling in the England and Wales LGPS, and other options in the review. As part of this, some responses said several smaller and medium funds already enjoyed scale benefits so other options presented insufficient advantages to justify change. Changing the structure of the scheme would not resolve all the challenges it faces currently; earlier reforms needed time to bed in and incremental changes were preferable.

Strathclyde: Several responses noted that Strathclyde Pension Fund with £21.5bn in assets had a singular position as the scheme's only very large fund – or largest fund by a considerable margin. Scale benefits for Strathclyde were seen as limited, the fund could already directly invest in infrastructure and the fund itself suggested that additional scale could bring diseconomies.

The case for changing the status quo

In making the case for change or against the status quo respondents' key points of reference were: that the present scheme was not optimal; all scheme members should have access to the benefits of scale; and that there were dis-benefits from a regional structure:

Status quo not optimal: Responses acknowledged the stable financial position of the scheme but argued that this was not optimal, with rising contribution rates, falling employer participation, treatment of cessation liabilities, conflicts of interest caused by the administering authority model and the protection of benefit levels being of particular concern. The fiduciary duty of funds should compel them to actively consider if alternative structural options best serve their members. The current stable financial position of the scheme presented a better time for structural change than in response to a crisis.

Benefits of scale: Respondents argued that smaller funds in the SLGPS did not benefit from lower investment fees and other economies enjoyed by the scheme's large funds, such as the ability manage funds in-house, hire skilled employees to manage operating risks or to directly invest in complex assets such as infrastructure. Smaller funds were seen as less able to deal with challenges facing the scheme relating to governance, reporting, rising regulatory overheads and operating risks.

Disadvantages of regional structure: Responses said the regional structure of the scheme had disadvantages and was a particular problem for multi-fund employees and third-sector

[6] Several respondents argued that Option 2 represented the status quo along with Option 1 and this is addressed in the next section.

admitted bodies. A regional structure was seen as a barrier for funds to implement best practices, apply consistent policies and access specialist skills as well as heightening funds exposure to budgetary and conflict of interest risks from administering authorities. A regional structure posed high interaction costs for multi-fund employers and a mismatch of footprint meant they were risk of being treated as closed employers.

Infrastructure policy as a driver for structural change

Responses for and against the status quo generally agreed that public policy on infrastructure investment should not be used as a justification for changing the structure of the scheme. Many responses acknowledged that larger funds had better access to infrastructure but this should not be an *a priori* reason for structural change. Structural change should be strategically focused on the long-term benefits to members rather than external objectives. Instead, most agreed that there was a role for public policy on the supply-side to increase the availability of infrastructure investments suitable for scheme funds.

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

Based on the analysis of responses, the following conclusions are drawn on respondents' views towards the second option – retain the current structure with 11 funds but promote cooperation in investing and administration between different funds.

a) Investment costs

Respondents agreed that the funds in the scheme could benefit by cooperating to reduce investment management costs but there were economies to cooperation that could restrict benefits to particular funds. The greatest gains could prospectively come from sharing internal management resources.

Fee savings: Many respondents said that existing cooperation between funds showed that this model worked and cooperation through joint procurement could boost fund purchasing power to cut fee in external investment management and allied services such as ESG advice and proxy voting. But savings outside these areas were likely to be limited, as funds already benefited from existing national procurement frameworks. Savings on fund manager procurement would most likely for 'expensive' active funds and alternative assets as passive fees were already very low.

Economies of cooperation: Respondents noted cooperation would need to benefit all participants and that benefits were more likely to be found among participants with more similar investment strategies. Smaller funds were most likely to benefit; larger funds less so, Strathclyde Pension Fund thought savings were unlikely to be material for instance. This might put small funds at a disadvantage, because although they stood to benefit the most from cooperation, they would find it more difficult to find resources to participate.

Internal management: Some respondents said that the greatest savings would come from sharing internal management resources rather than jointly procuring external managers. Barriers to such in-sourcing would be regulatory requirements and staff costs.

Downsides: Respondents cited downsides such as the stakeholder opposition, costs of participation, and potential concentration of investments among fewer managers.

b) Governance

Respondents agreed funds would need to align their governance structures to pursue cooperation, perhaps to the extent of delegating investment strategy implementation and fund manager selection. Such structures could dilute local governance and shift more decision-making authority to executives. Cooperation may not reduce governance overheads but some responses suggested additional benefits through shared resources.

Alignment of governance and scalability: Respondents said that alignment of governance structures would be necessary for cooperation to yield benefits. Lothian Pension Fund, a nexus of cooperation between SLGPS funds currently, was concerned that the model was difficult to scale and decision-making would prove too unwieldy unless funds adopted similar governance arrangements. Falkirk and Fife had delegated investment strategy implementation and selection of investment managers to their CFOs based on advice from their joint investment strategy panel but this was uncommon elsewhere in the scheme. Many responses reported similar concerns.

Impact on governance resources: Responses were unclear on the impact would have on governance resources required for the scheme. The Lothian Group said funds still needed personnel to maintain 'professional investor' status and help make investment decisions and

other responses noted that cooperation would not remove governance overhead or due diligence requirements. On the other hand, responses said there could be benefits from sharing of best practices, greater scrutiny of investments, reduced key person risk and reduced duplication of efforts.

Dilution of governance: Some responses said that the need for funds to delegate decision-making authority under cooperation could lead to dilution of local governance. This included reduced influence for elected members in favour of officers and the fund executives.

c) Operating risks

Responses produced little consensus on whether cooperation would improve or worsen the management of operating risks in the scheme. Although funds could rely on their existing arrangements to manage operating risks from cooperation; it was uncertain whether clubbing together with others would yield efficiency or effectiveness benefits; and there were a set of new risks to manage, mostly in relation to preventing the failure of governance agreements.

Existing capability would cover cooperation agreements: Some responses suggested cooperation would have limited impact on the management of operating risks so long as funds retained responsibility for investment decisions, maintained their operating risk practices and put in place robust monitoring arrangements. Existing voluntary cooperation and participation in national procurement frameworks showed that funds had experience in managing this type of risk.

Resource sharing may or may not produce synergy benefits: Respondents disagreed whether resource sharing produced by cooperation would reduce operating risks. At a high level, sharing of skills, resources, best practices and processes were suggested as having a positive impact. When respondents examined these in more detail there was less certainty. Cooperation could:

- reduce key person risks in smaller funds OR be uncertain as larger funds would not necessarily have the resources to help in all circumstances.

- reduce duplication of effort through sharing OR lead to no change as funds would still need to retain specialists and systems OR require additional resources to implement and maintain agreements.

- improve risk management through sharing of specialist skills OR cause funds to unwisely shrink their administrative capability OR cause skills gaps as experienced staff to migrated to lead organisations.

New operating risks: Some respondents suggested the cooperation exposed funds to new operating risks, including: failures in governance agreements; regulatory risks from additional FCA authorisations required; and the potential of participants to rely on others for due diligence. Failures in governance agreements could lead to overly slow decision-making; legal risks from service failure or poor investment performance and key person risks from staff executing cooperation agreements.

d) Infrastructure

Respondents were uncertain whether cooperation would increase direct infrastructure investment by the scheme. Incentives, such as model arrangements would be required to increase investment by large funds. Although cooperation would likely assist smaller funds to access direct investments, this might not be by a significant magnitude in relation to the scheme as a whole. Care would need to be taken managing potential conflicts of interest relating to local investing.

Assistance or incentives: Some responses said that assistance or incentives would be required to increase investment by the scheme as large funds were already investing directly or jointly in infrastructure. To encourage more investment by all funds, the Scottish Government could produce guidance, model arrangements or regulation. Although cooperation could encourage smaller funds to directly invest in infrastructure by lowering entry costs, small funds' potentially limited asset allocation meant overall direct investment by the scheme may not increase significantly. Funds may also have chosen not to invest in infrastructure as the duration and returns did not match their maturity profiles rather than due to entry costs.

Benefits of cooperation for infrastructure: The potential benefits from cooperation included overcoming cost barriers through joint spending on consultancy, due diligence and legal review; addressing lack of expertise through resource sharing; and removing limitations on the buying power of individual investors. This would give small and medium funds access to large scale investments and provide additional portfolio diversification to the scheme while investing in the UK economy could boost the public image of the scheme.

Negatives of cooperation for infrastructure: Although cooperation might lower entry requirements small funds still may not have sufficient resource to participate. Cooperation could lead to concentration or risks among particular investments or managers; and smaller more 'local' investments could be passed on in pursuit of larger scale opportunities. Joint investing could produce conflicts of interests, for instance the interests of more influential parties might to take precedence; or investments might be made for non-financial reasons to suit particular local interests. Infrastructure investing could lead to a mismatch between private and public sector interests.

e) Summary of reasons for supporting and opposing Option 2

The case for cooperation

Respondents suggested the benefits for investing, governance, operating risks and infrastructure made the case for cooperation. Key among these were benefits to smaller funds through reductions in costs and sharing of resources. Respondents also said that existing collaboration between funds showed that the cooperation model worked for the SLGPS. But there were differences between respondents in how cooperation could be pursued:

Incentivised or compulsory: Many respondents said cooperation should be pursued for its benefits either, in its own right, or, in tandem with structural change, but *only* in conjunction with incentives or compulsion to ensure all funds were actively engaged. Otherwise it would just reflect the status quo and not yield any change to the SLGPS. Many respondents who were otherwise supportive of the status quo in the SLGPS felt that incentives or compulsion was necessary for cooperation to be of benefit while respondents who preferred pooling or merger said compulsory cooperation could yield significant benefits in the short-to-medium term while structural change was implemented. The Robertson Trust–SCVO response suggested that existing cooperation between funds was in fact relatively limited despite clear benefits suggesting compulsion was required.

Reflects the status quo: However, some respondents preferred cooperation because it represented the status quo. They felt cooperation should be voluntary, or incentive based, as it gave them the greatest degree of freedom to address their members' interests. Voluntary cooperation would also avoid the disadvantages of pooling or merger, revisiting a reason for supporting Option 1 that there was insufficient empirical evidence of the benefits of scale in

investment costs or performance from the merger or pooling to justify the risks to investment performance, member participation, funding, employee contribution rates, or local conditions.

Frameworks to assist cooperation: Several responses, including Strathclyde Pension Fund, suggested some re-organisation of the scheme could assist cooperation. Key elements in the Strathclyde response include: an active programme to promote joint investment, procurement and resource sharing; joint activity on ESG issues; shared administration and communications; additional resources for SAB or funds; a formal fund conveners meeting; and establishment of three hubs for the north, west and east of Scotland. Additional suggestions for cooperation outside this framework included administrative activities such as publishing; joint procurement of the Aquila Heywood Altair Pension Administration system and member education.[7] Respondents also suggested beefing-up SAB to add impetus to cooperation, and although the means were not specified, it was suggested the board have a greater ability to compel funds to participate in cooperation frameworks or adopt transparency measures.

The case against cooperation

Respondents identified significant problems for cooperation including that it could be difficult to scale, could require additional funds to adopt internal management, retains regional disadvantages and could be sub-optimal compared to pooling or merger.

Scaling problems: The Lothian model of cooperation was frequently cited as evidence that the SLGPS could pursue cooperation to the benefit of the scheme's investment costs, governance, operating risks and infrastructure investment. But some participants in the arrangements had doubts whether the Lothian model could scale widely in the scheme. Respondents said cooperation took significant time to establish and required a high degree of delegation that could be unpalatable to some funds. The Lothian Group felt that a significant element of its cooperation arrangements – the joint investment strategy panel with the Falkirk and Fife funds – would not scale beyond its existing membership of three participants. Other responses suggested that separating fund governance from administering authorities – an independent executive – would be necessary for this cooperation to be scalable.

Requires funds to adopt and share internal management. Edinburgh Leisure suggested that because 92% of fund costs are investment management fees, cooperation would be sub-optimal unless funds brought investment management in-house and then shared their internal managers as part of cooperation agreements. This was also true for pooling and mergers. The response recognises that most funds are too small to bring funds in house, so a potential implication of this response is that one or more additional large SLGPS funds would need to bring funds in-house, otherwise any cost saving from cooperation would be limited.

Doesn't address the disadvantages of regional structure: Multi-fund employers suggested that, unless cooperation led to homogeneity between funds with a single point of administrative contact, it would not resolve their difficulties with the high interaction costs caused by the regional footprint of the scheme nor the risk of being treated as closed employers.

Sub-optimal compared to other options: Some respondents acknowledged the benefits of cooperation but said they still remained sub-optimal compared to pooling or mergers. These

[7] Voluntary investment pools were also suggested and these are dealt with in the next section.

revisited the arguments presented against the status quo in Option 1, including that it was better to make changes to the scheme under good conditions and that scale benefits were not enjoyed by all participants in the current set-up.

Option 3: Pool investments between the 11 funds

Based on the analysis of responses, the following conclusions are drawn on respondents' views towards the third second option - asset pooling, where the assets of distinct pension schemes are consolidated into one or more asset pools to be managed centrally on behalf of the different schemes.

a) Investment costs

Investment management costs

There was no consensus on whether pooling would reduce investment costs. Some respondents identified savings based on internal management of pools or broaching the fee thresholds of external managers. Because of this externally managed pools may benefit small funds only. Others said costs could be too high, there was an absence of evidence for benefits, or that pooling could lead to market concentration and reduced investment effectiveness.

Reduced fees and new asset classes: Several respondents suggested pooling could reduce investment management costs. The use of internal management, composition of externally managed pools and access to new investment classes were raised as key considerations.

- Internal management: The Lothian Group said internally managed pools could offer significantly lower costs than externally managed pools. The group suggested if pools achieved the costs of the Lothian Pension fund, SLGPS investment costs would be 80% lower leading to substantial cumulative benefits. If the SLGPS pools could lower their expense ratio from 0.47% currently to the level of the University Superannuation Scheme at 0.31% then the scheme could save £65m annually.

- Composition of externally managed pools: Some respondents suggested pools run by external managers would need to exceed particular thresholds in particular assets classes to reduce costs and thus pools may need to be compulsory. Falkirk Council Pension Fund gave as an example an external manager fee quotation of 0.54% for a £100m global equity strategy mandate or 0.39% for a £1b mandate. Others suggested that £25bn may be the minimum size for scale advantages based on the experience of LGPS pooling in England and Wales.

- Additional investment opportunities: Some respondents thought the additional scale of pools would allow them to invest in new asset classes such as infrastructure or private debt.

Economies of participation: Many respondents thought that pooling would be of benefit to small or medium funds by lowering costs or broadening portfolios. But large funds that already enjoyed scale benefits so may not see cost savings. For example Strathclyde Pension Fund said it already pays the lowest fee tier available to investors or a lower negotiated rate.

High set-up costs: Many respondents said establishing pools would be costly, time-consuming, with an overly long payback period to recoup costs. Some said that start-up and maintenance costs might not be recouped, leading to lower net returns for funds, a detriment to funding levels and higher contribution rates.

Absence of benefits: Some respondents said that the LGPS pooling in in England and Wales had showed pooling produced lower-than-expected costs benefits, or that this exercise needed to run longer before benefits could be demonstrated. Others said that reforms in England and Wales had already passed on cheaper external investment management fees to Scotland, leaving little additional benefit to be gained from pooling. Some respondents said that there was no evidence that large funds necessarily have lower costs or perform better, citing the SAB's Mercer study as an example.

Concentration and reduced investment effectiveness: Some responses said that pooling could lead to market concentration of external investment managers and poorer price competition. Large pools might also suffer from restricted investment choice and have to pass on small profitable investments, especially for in-demand investments such as private debt or infrastructure. Some said pooled investments may be a mismatch for the liabilities of particular funds.

When should funds consider joining an asset pool?

Some respondents said funds should consider joining asset pools only if the SLGPS was in a significantly worse funding position. Others suggested pooling should be considered if clear evidence of the costs and benefits became available and a fund's analysis showed pooling would best meet its fiduciary duties to members. If pooling showed benefits, some respondents said joining a pool would be the same as any other investment decision.

Particular issues funds should consider before joining a pool included: resourcing; alignment of interest; investment options offered by the pool and associated costs; track record; and operational risks. Some respondents said passive investment pools were most likely to meet more funds requirements. Other said pools may be selected because they could offer investments funds could not access by other means.

When should the SLGPS direct funds to pool?

Some respondents thought the decision to pool should only ever be a voluntary decision by funds. Others said funds could be directed if there problems with current fund operations or a strong business case for a particular fund was presented.

Problems that could lead to compulsory pooling included underperformance; inability to meet investment objectives; sustained evidence of governance failures; lack of sustainability; an inability to meet long-term liabilities on an actuarial basis; and potential for detriment to members and employers.

b) Governance

There was no consensus on the impact of pooling on fund governance with the benefits of retaining local influence and stakeholder involvement while gaining skilled resources and scale balanced against increased complexity; retention of duplicate structures and diseconomies of scale.

By retaining existing arrangements, pooling kept governance local but maintained duplicate governance structures. Investment decisions could improve with greater specialist influence or worsen through complexity and insufficient granularity. The set-up and running costs of pooling could be greater than any administrative savings. New governance risks would need to be managed including internal manager capture and dilution of stakeholder influence in favour of executives.

Retention of existing structures: Retaining existing local governance arrangements could be a positive or negative feature of pooling. It could allow funds to maintain their existing

decision-making capability but meant the SLGPS still paid for these duplicate arrangements, limiting the ability of pooling to drive down costs.

Investment decision-making: Pooling could either improve decision-making by resource sharing and delegating more control to specialists or it could reduce flexibility by adding an extra layer of bureaucracy:

- Better decisions: Sharing resources and giving more funds access to specialist personnel could improve investment decision-making. Specialist internal managers might make better decisions. Handing over responsibility for selecting external managers to specialists could yield benefits.

- Worse decisions: Complex governance arrangements - the organisation charts of some pools in England and Wales were shown as evidence - could make decision-making unwieldy, particular where pools were externally managed. Responsibility for investment decisions could become unclear leading to conflicts. Pooling could lead to a loss of granularity in the investments available to funds and a one-size-fits approach to ESG policies. It could draw key personnel away from funds to work at pools reducing the decision-making capability of funds

Costs: Respondents disagreed whether pooling would reduce or increase governance costs. Setting up and maintaining for pools would be costly in time, money and staff resourcing. Pooling could lead to unwanted diversity of operating models – it was suggested there were 5 different models in England and Wales. But it could reduce transaction costs and reduce duplication of back office investment administration.

New governance risks: Internally managed funds could become captive and difficult to replace when underperforming. Pooling could reduce the influence of pension committees and stakeholders in favour of executives and require new measures to prevent dilution of influence. As pools are subject to FCA requirements and funds to local government regulations there could be regulatory conflicts.

c) Operating risks

There was no consensus whether pooling raised or lowered operating risks. Respondents identified potential risks in pool-set up, oversight and investment strategy as well as risk reducing measures in access to staff with specialist skills, manager selection processes and diversification.

Externally managed pools: Some respondents suggested that externally managed pools represented the status quo so operating risks should not increase; others suggested pools would require a new, additional layer of risk monitoring.

Internally managed pools: Respondents suggested that internally managed pools would require equivalent standards of risk management and compliance to equivalent external fund managers otherwise operating risks would be greater than in SLGPS currently as most funds are externally managed.

Pool set-up: Gathering resources to establish pools and transactions to establish portfolios were cited as raising operating risks. This included diverting staff from their current duties in the SLGPS to establish pools and timing of financial transactions to build portfolios.

Pool oversight: A new oversight layer for pools was cited by some respondents as reducing risks through improved resourcing, reduced key person risk and using skilled staff to oversee of external manager selection. Others said unclear or changing responsibilities and accountability would increase operating risks.

Investment risks: Pooling could lower or spread investment risks through diversification across asset classes and by allowing specialist pools to be set-up for particular asset classes or infrastructure projects. They could increase risks by making larger individual investments and reducing diversification; concentrating investments with a smaller number of managers or by growing to excess scale and experience diseconomies. Some respondents said efforts to recoup pool set-up costs could lead to pools adopting riskier investment strategies.

d) Infrastructure

There was no consensus among respondents on the impact of pooling on infrastructure investments. Pools might not create additional capacity in the SLGPS to invest in infrastructure but through greater scale and packaging investments to suit scheme funds they could lead to higher investment.

Economies of participation: Respondents said there were likely to be economies of participation in infrastructure pool investing, with small and medium funds more likely to benefit, but in this case pooling would not raise infrastructure investment by the scheme substantially as smaller funds had limited capacity to invest in these assets.

Large funds said they already invest in infrastructure pools – for example, Strathclyde Pension Fund cited its participation in the mutually owned Pensions Infrastructure Platform. Figures cited by Strathclyde suggest that small funds with assets of less than £1bn had made no investments in infrastructure but as their total assets were around £2.3bn, small funds' potential investment in this asset class would be limited. Some smaller funds said they were currently considering infrastructure investments but some had not chosen not to invest in these assets as the duration and returns did not match their maturity profiles.

Scale benefits and diversification: If a combined infrastructure pool was sufficiently large some respondents thought it would offer scale benefits of lower entry costs, the ability to make larger investments, access to specialist resources and the ability to develop a bespoke vehicle structure. This may raise overall investment in infrastructure by the SLGPS.

Creating new pools for SLGPS funds: Respondents discussed the merits of creating new infrastructure pools dedicated to SLGPS funds as opposed to pooling funds in their entirety. Some respondents suggested such pools could provide investments packaged to meet the risk, inflation and maturity characteristics desired by SLGPS funds; inspirations included the Pensions Infrastructure Platform and the Scottish Futures Trust report which suggested that Scottish real estate might be a good investment for LGPS funds. Problems of this approach against funds' existing pooling activities included large costs to set up the pool and the need to seek FCA authorisation for the pool.

Political risks and investment effectiveness: Respondents said that public policy objectives to raise infrastructure investment could conflict with fund investment objectives and fiduciary duties. Pools themselves may pursue investment strategies that were a poor match to certain funds.

e) Summary of reasons supporting and opposing option 3

The case for Option 3: pooling

Only one respondent, Unite, preferred pooling as a first option, but several respondents discussed the case for pooling; Robertson Trust and SCVO for instance describing it as a minimum required step. Unite preferred pooling for reasons discussed earlier in this section including that it would not lead to job losses of the merger option; allowed spreading of risks; improved SLGPS buying power; retained local governance structures; and reduced

administration costs. When discussing the case for pooling, key considerations respondents discussed were:

Single or multiple pools: Respondents differed on whether there should be single or multiple pools. Unite preferred three or four pools, other respondents suggested that pools would need to at least £25bn in size to gain investment scale benefits, the Police Scotland–Police Authority Scotland response suggested a number of pools that would allow for the different investment strategy needs of funds in the scheme. This response gave as an example funds with a stronger funding position preferring a pool with a low risk investment strategy. Some respondents who preferred multiple pools also said a single pool could have more challenging governance requirements.

The Robertson Trust–SCVO response suggested that a single pool at £42bn in assets would not be excessively large. It would be roughly double the size of the existing largest fund, Strathclyde, but similar in scale to three of the English pools and larger than the three of the others.

Voluntary or compulsory: Some respondents supported the idea that pooling could be promoted as a voluntary option where it met the requirements of different funds. Strathclyde Pension Fund for instance, already enjoys scale benefits so should not need to pool. Other funds might need the freedom to select pools with complementary risk-return profiles or to access specific asset classes such as infrastructure. It was not clear how pools should reach the thresholds where scale benefits became available.

Governance, costs and internal management: Responses suggested that pooling would need to be internally managed to deliver meaningful cost reductions and prevent overly bureaucratic governance. Unite's response said that lack of oversight and control in governance, and lower-than-expected cost savings in England and Wales showed that pools in Scotland should be internally managed. Other respondents said not implementing an additional layer of governance between the fund and the investment manager was the key for pooling to have more success than England and Wales. Edinburgh Leisure's argument relating to cooperation also applied here, which was because investment management fees make up 92% of scheme costs, pooling would be sub-optimal unless funds brought investment management in-house.

The case against Option 3: pooling

Arguments against pooling suggested that the scheme conditions didn't justify change; the case hadn't been made for pooling; internal management offered surer cost savings; pooling could lead to national concentration of risks and pooling didn't resolve admitted bsodies problems with cessation.

Scheme conditions: Respondents revisited the 'if it isn't broken, don't fix it' position in favour of Option 1 that the SLGPS is a success story and so the status quo should be preferred.

Case has not been made for pooling: Some respondents said that they hadn't been presented with a clear case that allowed them to evaluate the advantages and disadvantages of pooling and so it was not possible to make an informed response. In general, respondents revisited the argument in favour of Option 1 that that there was insufficient empirical evidence of the benefits of scale in investment costs or performance from pooling to justify the risks to investment performance, member participation, funding, employee contribution rates, or local conditions.

Respondents said that pooling in England and Wales suffered from a lack of a standardised approach or clearly planned strategy; lower-than-expected savings; long payback periods;

stripping of skilled employees from administering authorities to set up pools; and significant governance problems. The structure of the SLGPS where one fund – Strathclyde – holds roughly half the assets was said to be significantly different so that evidence in England and Wales might not apply. Although a Scottish approach to pooling was being developed by the Scottish Futures Trust it was focused on infrastructure and property and still in its early stages.

Internal management should be pursued first: Some responses thought the SLGPS should focus on moving management in house as a surer means to generate cost savings than pursuing pooling.

Concentration of risk versus benefits of regional diversity: Some respondents suggested pooling could create a single point of failure for the SLGPS and that the existing regional structure offered diversification benefits.

Retains segregated liabilities, so leaves cessation issues unresolved: The Robertson Trust-SCVO response said pooling would not resolve the cessation issues encountered by charitable and admitted bodies because pooling would preserve specific employer responsibility for liabilities with funds retaining their allocations of assets and liabilities.

Infrastructure policy as a driver for pooling

Responses for and against the pooling generally agreed that public policy on infrastructure investment should not be used as a justification for changing the structure of the scheme, however, as discussed earlier, creating voluntary pools to boost the supply of infrastructure investments was considered appropriate.

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

Based on the analysis of responses, the following conclusions are drawn on respondents' views towards the fourth option – merging SLGPS funds into one or more funds.

a) Investment management costs

Investment costs

There was no consensus among respondents on whether mergers would lower investment costs. Some respondents said mergers would produce economies of scale and if merged funds adopted internal management like other large funds globally, the Lothian Group estimated the scheme could make annual savings of £65m leading to cumulative gains of £1bn by year 10. Other respondents said that that there was insufficient evidence of additional scale benefits available from merging SLGPS funds, potential for diseconomies, and that difference in investing costs between funds were minor. The costs of setting up and maintaining merged funds could have a negative impact on scheme net returns, local jobs, funding and contribution levels. Any cross subsidisation of liabilities from merged funds could raise the contribution levels of employers at the better funded funds.

Economies of scale: Respondents suggested that merged funds would have the buying power to demand lower external investment fees but this process would lead to the greatest reduction in costs for smaller funds; larger funds such as Strathclyde may not benefit. Some respondents thought that all funds could benefit by being able to access direct investments which previously had high entry costs or required large scale investments and savings could be gained by reduced use of expensive investment vehicles. Falkirk Fund with £2.3bn in assets said that every reduction in fees of 5bps (0.05%) translated into annual saving of c£1.2m. UNISON cited the APG study suggesting the presence of a single merged fund in Scotland would have deliver annual benefits of £830m with each basis point saving the scheme £3.5m. Cost savings would not be immediate but gained as existing mandates with external managers were re-let. Savings would be greatest in expensive asset classes and lowest in cheaper passive funds.

Lack of evidence: Some respondents suggested that there was insufficient evidence that larger funds had lower costs or produced better returns than smaller funds and there was no certainty to where the tipping point where economies of scale could be won so mergers did not guarantee real benefits. SLGPS funds may already enjoy scale benefits or have benefited from fee savings passed on from reforms in England and Wales. The SAB's snapshot analysis of the LGPS 2015 accounts by Mercer for the SAB was cited as showing that larger funds do not always have lower costs and perform better and Audit Scotland analysis of fees were said to show that SLGPS funds did not have significantly different investment costs.

Internal management: The ability of large merged funds to manage assets in-house was cited as the primary means that merger could reduce investment costs by some respondents. The Lothian Group suggested that it was global practice for large funds to manage a substantial proportion of funds in-house, ranging from c100% for Sweden's largest fund Alecta; 80% for the largest 10 funds in Canada; 75% the UK's largest fund USS; 75% for the largest US state fund CalPERS; a planned 50% for Australia's largest fund AustralianSuper to 45% for US funds with assets above $50bn.

Lothian Group said that USS enjoyed 34% lower investment fees than the SLGPS largely because it managed c75% of assets in house versus 10% for the SLGPS. The response

estimated that the SLGPS could make annual fee savings of £65m per annum if it achieved the USS expense ratio of 0.31% and this could be done by bringing only liquid assets in-house. Savings would be subject to compounding with £65m in annual savings leading to cumulative gains of £1bn by year 10, assuming an internal rate of return of 5%. The response said savings of this magnitude would outweigh initial outlays required to merge funds.

Other scale benefits: Respondents said by providing greater scale, mergers would provide funds with additional means to control investment costs, including access to specialist expertise, one set of principles for ESG investing, tendering costs for external management, and centralisation of best practices and systems. Savings on administrative costs unrelated to investment management were also cited as scale benefits of mergers, and the APG study was cited here.

Costs and impact on net returns, funding and contributions: Respondents said that merged funds would be costly to set up and maintain and some suggested this could have a negative impact on scheme net returns, funding and contribution levels. Costs included restructuring of mandates, transition of assets, additional skilled staff in the case of internal management and fees to advisors. The Abertay Housing Association if the Tayside Pension Fund required a 1% increase in contribution rates it would lead to increased costs of £10,000 for the association, and a 0.14% increase in rents for tenants. As well as being a drag on performance, a merged fund could seek to recoup costs by investing in riskier higher returning assets. The Tayside Pension Fund suggested the difference in local funding rates versus standard rates at 2014 valuations demonstrated the potential impact on contribution rates.

Impact of consolidating liabilities on funding levels and contribution rates: Some respondents feared that mergers would lead to raised contribution rates for employees of better funded pension funds. These employees would be exposed to lower funding levels when liabilities of their existing fund were consolidated with less well funded pension funds. A new portfolio of merged assets and liabilities would require new asset allocation strategy for the new funds linked to the new liability funding level and a new combined actuarial valuation

Diseconomies of scale: Some respondents said mergers would create a mismatch between asset allocation strategy and employer policies, member longevity profiles or liabilities if segregated. Investment decisions could become more bureaucratic and less efficient, while mergers could lead to concentration of investment managers, a loss of ability to participate in smaller scale investments or become too big to manage effectively.

Job losses: Merger could lead to job losses and a loss of financial expertise at administering authorities. Raised contribution rates could lead to job losses among employers members. The Care Inspectorate–Scottish Social Services Council response suggested that a rise in contribution rates of two-to-three percentage points on the 17% levied currently by the Tayside Pension Fund could be problematic in Dundee which tends to have higher unemployment than elsewhere in Scotland.

When should funds consider merge?

Respondents said that the considerations funds could use to decide when to merge were:

- A mutual consideration by two or more funds
- A thorough cost-benefit analysis that showed better outcomes for members than the current structure for all funds

- Ideally, an evidence base of costs and returns from merged funds of a similar scale
- The funding positions of individual employers are protected
- Satisfying regulatory requirements for consultation with local authority employers;
- Ratification in statue rather than being a local agreement
- Subject to finding appropriate governance arrangements

The Lothian Group gave a detailed business case for merger, which contained the following additional elements:

- Separation of funds from administering authorities with wide stakeholder representation in governance
- In-house management and delegated investment strategy to executives
- Service delivery to members and employers retains a 'local' connection

When should the SLGPS direct funds to merge?

Some respondents thought the decision to merge should only ever be a voluntary decision by funds. Others said funds could be directed to merge if there problems with current fund operations or a merger would deliver the best outcome for scheme employees, pensioners and employers.

Problems that could lead to compulsory merger included underperformance; inability to meet investment objectives; sustained evidence of governance failures; lack of sustainability; an inability to meet long-term liabilities on an actuarial basis after a deficit recovery plan agreed with the scheme actuary; failing to achieve their objectives which can be attributed to poor investment returns and high fees; and potential for detriment to members and employers.

Respondents disagreed on when the Scottish Government should intervene. Scottish Borders Council suggested that as mergers required statutory change and intervention by Scottish ministers they should only be considered as a last resort. The Lothian Group said that the Scottish Government could specify a new merged structure for the SLGPS within a specific timeframe if periodic scrutiny of the scheme, including the current review, showed it to be beneficial.

b) Governance

Responses contrasted the benefits for governance of the greater resources available to large funds, and consistency of approach, against the potential for a loss of input by regional stakeholders. Larger merged funds might enjoy better governance as they were better resourced and the scheme as a whole might benefit from greater consistency of governance from a fewer number of large funds. The new governance structures merged funds would require might share governance among a wider set of stakeholders than currently. But merged funds might allow less local input and reduce the influence of particular stakeholder groups such as employers. The current arrangements could be intrinsic to the successful performance of funds.

Scale and governance effectiveness: Some responses suggested larger, merged funds would enjoy more effective governance due to scale benefits, although this would likely only apply to smaller funds in the scheme. Some respondents said reduced duplication of

governance structures would lower costs others said set-up costs could be significant, including higher salaries need to attract appropriate staff.

Respondents said mergers would rationalise the sets of investment principles used in the scheme and streamline decision-marking. Larger funds would have access to more specialist staff, including those with expertise in dealing with charities and admitted bodies. The boards and pension committees of larger funds could be staffed by members with expertise in pensions.

Choice of governance model: Respondents said merged funds would need new governance structures. Potential models could include joint boards or a pensions authority – precedent for this was the creation of the South Yorkshire Pensions Authority from the merger of metropolitan county council funds in 1988. The model chosen would depend on whether the scheme merged into a single or reduced number of funds. Reducing the dominance of administering authority councils and the inclusion of other councils and employers was seen as a benefit of this approach.

Consistent national approach: Merged funds could bring greater consistency to funding, actuarial valuations and pensions administration which could be helpful to multi-fund employers and third sector organisation. National guidance would be more likely to implemented than in the current scheme where it was said to be ignored in some cases.

Reduced accountability and local involvement: Some responses said merged funds could be less accountable as they would serve greater numbers of stakeholders; others said that the wide constituency of Strathclyde Pension Fund showed merged funds could accommodate a large set of employers and members. Merged funds would also need governance structures to deal with the risk of political interference from central government.

Several respondents said mergers would reduce local involvement and some felt this to be intrinsic to the successful performance of their fund. Respondents said councillor, employer and union representation would disappear, although neither of the two union respondents raised this particular concern with mergers.

c) Operating risks

A scheme with merged funds could have better resources to manage operating risks than it does currently but the trade-off could be greater concentration of risks. The merge process would carry execution risks including administration and member servicing concerns that would require a management strategy. Former administering authorities may face risks caused by loss of financially knowledgeable staff.

Better resourcing: Some respondents said that larger merged funds would have access to more specialist resources than small and medium funds enjoy currently so that operating risks for the scheme as a whole would be better managed. This would additionally reduce key person risks. Funds would also have access to greater depths of specialism including the functional areas of investment, administration, risk management, accounting, funding, legal, governance, communications, tax, data management and compliance. Larger funds may also have access to better but more expensive risk management systems and analysis tools.

Concentration risks: Merging funds could increase risk by concentrating investments with a smaller number of funds and managers and excess scale could lead to diseconomies. In the scheme currently, the risk of poor performance was spread among 11 administering authorities; a fewer, large number of funds would reduce this diversification. Larger funds may need to make bigger individual investments and be unable to access smaller investment opportunities.

Execution risks: The process of merging funds carries execution risks including short-term operational risks while the merger is implemented, including uncertainties among current staff administering the scheme. To manage these risks respondents suggested that decisions were made and implemented as quickly as possible, with appropriate engagement and communication.

Administration and member servicing risks: Respondents suggested mergers may carry the risk of administrative failures, worsening servicing levels and unsettle membership leading to transfers or discouraging new entrants. Some respondents said recent mergers of other national services suffered from a lack of clear objectives and had been controversial and problematic as a result. Managing these risks would require robust and transparent governance and swift implementation of mergers.

Risks to administering authorities: Some council administering authorities could face job losses and reduced administrative capacity if there were shared roles between councils and funds. Councils may lose financial expertise and face redundancy costs. The impact of funding levels on contribution rates was raised

d) Infrastructure

Respondents disagreed on the impact mergers would have on infrastructure investment by the scheme. Although larger funds might have a greater appetite for infrastructure, the scheme could already be investing close to capacity with additional gains limited. Merged funds could be subject to diseconomies and political risks. Public policy measures would be needed to generate the larger scale infrastructure investments that merged funds might require.

Economies of scale: Respondents were unclear whether merged funds would invest materially more than the scheme does currently. Larger, merged funds may have a greater ability to invest, be less deterred by cost barriers and thus have a greater appetite for infrastructure than the scheme does currently. Existing funds-of-funds investments in the scheme could potentially be transferred to direct infrastructure vehicles with lower fees. But in the current scheme, large funds which account for the majority of scheme assets already invest in infrastructure. The maturity and risk profiles of infrastructure investments may not match the liability profiles of the membership of funds who do not currently invest thus bringing these members into a merged fund would not raise overall investment.

Investment availability: Merged funds could prefer larger investments, and some respondents providing these investments would require public policy support from the Scottish Government. Australia's approach to investing in infrastructure was mentioned as a model.

Diseconomies of scale: Merged funds may be subject to diseconomies in investing in infrastructure. They could require large scale investments putting smaller investments off the table, and large investments may take a longer time to complete. The investments large funds make could be a poorer fit with the requirements of the scheme membership than the current structure.

Political risks: Public policy measures to promote infrastructure investment could conflict with funds' investment objectives and fiduciary duties. The governance of any merged funds should be structured to minimise such risks.

a) Summary of reasons for supporting and opposing option 4

The case for mergers

Respondents cited the benefits to investment costs, governance, operating risks and infrastructure investment described earlier in this section but raised the following additional considerations:

Involuntary mergers when a business case was present: Some respondents said that funds could be directed to merge if a business case, risk assessment and due diligence that demonstrated merger would be in the best interest of all members and employers. This business case should include timescales, costs of implementation and modelling of the impact on the affordability of the LGPS in the medium–long term, as well as analysis of the impact on the funding levels of the schemes, including the actuarial basis of the analysis and the funds' demographic profiles. This analysis should focus on the net bottom line impact on the fund rather than costs and the process should ensure no diminution in service levels to employers. Scottish Police–Scottish Police Authority said that directed mergers would be necessary if funds were merged in stages or merged into more than one fund to make this option viable.

Voluntary mergers when a business case is present: Respondents who preferred merger said it should be compulsory but voluntary mergers should be encouraged until the Scottish Government chose to enforce them. Two funds said they wished to build business cases and explore mergers – the Lothian Pension Fund said it wanted to voluntarily work with like-minded funds on a mutually beneficial merger and the Falkirk Council Pension Fund said that it would prefer to merge with the Lothian Fund due to the strong existing ties between the funds.

Although it preferred directed mergers, Edinburgh Leisure suggested that if a policy of voluntary mergers were pursued then the SAB should schedule a review in five years that would lead to enforced mergers for funds that cannot meet best practice standards set by the body. Standards would include total costs as a proportion of fund values and meeting investment performance benchmarks. The standards would be based on the updated transparently standards suggested earlier in this report to ensure funds costs and performance were comparable.

Status quo not optimal: As with Option 1, responses acknowledged the stable financial position of the scheme but argued that this was not optimal, with rising contribution rates, falling employer participation, treatment of cessation liabilities, conflicts of interest caused by the administering authority model and the protection of benefit levels being of particular concern.

Benefits of scale: Respondents suggested that fund mergers had been successfully conducted in the past so the model was in fact tested. The merger of county and town council funds during local government re-organisation in 1975 and the creation of the South Yorkshire Pensions Authority were cited as examples. As with Option 1, respondents argued that mergers should be pursued because some funds in the SLGPS did not benefit from lower investment fees and other economies enjoyed by the scheme's large funds, such as the ability manage funds in-house, hire skilled employees to manage operating risks or to directly invest in complex assets such as infrastructure.

Preferable to pooling due to governance: Respondents said mergers were preferable to pooling because they did not introduce an additional governance layer which came with the potential for poorer or less accountable decision-making.

Resolves disadvantages caused by regional structure: As with Option 1, respondents said merger could resolve the difficulties caused by the scheme's regional structure including

consistency issues for admitted bodies, high interaction costs for multi-fund employers, and a mismatch of footprint which meant multi-fund employers were at risk of being treated as closed employers.

The case against mergers

Scheme conditions: Respondents revisited the 'if it isn't broken, don't fix it' position in favour of Option 1 that the SLGPS is a success story and so the status quo should be preferred.

Case has not been made for merger: Some respondents said that they hadn't been presented with a clear case that allowed them to evaluate the advantages and disadvantages of merger and so it was not possible to make an informed response.
In general, respondents revisited the argument in favour of Option 1 that that there was insufficient empirical evidence of the benefits of scale in investment costs or performance from mergers to justify the risks to investment performance, member participation, funding, employee contribution rates, or local conditions. In the specific case of mergers, Strathclyde Pension Fund said that size and scale benefits were not necessary a determinant of success. The UK's two largest pension schemes – British Telecom Pension Scheme and USS – each had deficits of more than £10bn.

Cross subsidisation of liabilities: The potential for cross subsidisation of liabilities to raise contribution rates for employers of better funded funds was a significant concern for many respondents. Some respondents said that employers were highly sensitive to contribution rates so increases could lead to job losses or a reduction of employers in the scheme.

Loss of local governance: Respondents said mergers would reduce their participation in governance and that a merged scheme could lead to lower participation from particular stakeholders such as admitted bodies, employers and unions. Some said that local governance was integral to the successful performance of funds.

Reduced administrative capacity: Some respondents said mergers could make it difficult for former administering authorities to manage other financial matters. As well as the issues discussed earlier in the section, the Orkney Islands Council said a merger could see it lose the capacity to manage £215m in investments associated with the operation of an oil port under the Orkney County Council Act 1974.

The public sector is unable to conduct mergers effectively: Respondents said that public sector mergers perform poorly and this risk was high for mergers in the SLGPS due to the scheme's administrative complexity. The Society of Personnel and Development Scotland Administration said service delivery had suffered after police and fire funds had been transferred to the Scottish Public Pensions Agency. Glasgow Kelvin College said that Audit Scotland had questioned the effectiveness of merger processes in the public sector.

Become too costly for admitted bodies: Shetland Islands Council Pension Fund said that admitted bodies may find it too costly to join the scheme if funds were merged because they may not enjoy similar terms as current admitted bodies; face excessive covenants or be barred by minimum size requirements. This may be more acute for island admitted bodies as they tended to be smaller in size.

How mergers should be implemented

Respondents explored how mergers should be conducted, what form merged funds should and best number of merged funds for the scheme.

Resourcing and reforms to support mergers: Some responses deal with resources to support mergers and reforms that would support mergers. Respondents said additional resources would be needed to support merging funds and that a significant body of work would need to be done by the Scottish Government and the Scottish Public Pensions Agency (SPPA). But this could be accomplished with sufficient commitment, a clear plan and a reasonable time frame. This process would need to take into account the day-to-day demands on trustees and officers. Legacy arrangements should be honoured but future arrangements for employees and members should be wholly consistent.

Respondents said that certain reforms to the scheme should be pursued in parallel to merger because they would support the process or because they would lead to short-medium term gains in their own right. These included improved compulsory adoption of transparency measures; greater monitoring role by SAB, adoption of internal management, shared infrastructure investment pooling with lead funds and compulsory cooperation with many of the measures suggested by Strathclyde Pension Fund.

Edinburgh Leisure suggested that the in-house investment management function of the Lothian Pension Fund could play a role in shifting a merging SLGPS towards internal management. Other LGPS funds could shift investment management to Lothian and the executive capacity of Lothian's investment management function could to be scaled up to incorporate the greater assets managed. Enacting the merger processes and reforms might require a separate governance mechanism to oversee the transition.

Governance of merged funds: Respondents said merged funds would need new governance structures. To resolve conflicts of interest in the current scheme, the administering authority model with a lead employer should be abandoned, and funds should become autonomous entities with their own governance structure and budgets. Governance arrangements should safeguard merged funds exercise of fiduciary duties from political risks, in particular public policy on infrastructure investment, or pressure to invest in local projects.

Potential governance models could include joint boards or a pensions authority – precedent for this was the creation of the South Yorkshire Pensions Authority from the merger of metropolitan county council funds in 1988. The model chosen would depend on whether the scheme merged into a single or reduced number of funds. Representation on these bodies should be wide. This would include councils and employers who are said to be currently under-represented by the administering authority model in the current scheme.

Local servicing: Respondents suggested that mergers should retain local servicing arrangements. Although becoming more centralised funds could retain local service delivery to service pensioners and deferred members who could not engage with the fund through an employer.

Merger into one fund: A merger into one fund would allow multi-fund employers to deal with a single administering authority and produce a fund big enough to incorporate global best practices. A single fund would bring management of the greatest number of investments in-house and provide the biggest scale benefits to governance, operating risks and infrastructure investments. The fund would be sufficiently large to be an active shareholder on ESG and other issues. If the merged fund had a joint board, it would avoid the governance problems of the current employer-led model, would be less prone to political interference than a non-departmental public body and be exempt from VAT.

Merger into two or three funds: Some respondents preferred that the scheme merge into two or three funds. This arrangement would allow merged funds to benefit from scale but maintain a higher degree of local accountability. Respondents also said that the Strathclyde

Pension Fund was already large enough so would not gain scale benefits from merger and multiple funds would be less susceptible to political pressure than a single fund.

Multiple funds could be structured to fit their geographical coverage, including whether there was one administrative centre for the fund or a central and regional offices to allow funds to remain close to customers. Such funds could also develop centres of excellence. Boards of funds would include wide stakeholder representation including pensioner and independent members with 10 year terms of office to ensure participants are knowledgeable about their roles.

Prevention of cross-subsidies: Some respondents, including those who did not prefer merger as any option, said mergers of the SLGPS should protect the funding positions of existing employers. Employers of better funded schemes should not face a rise in contribution rates as a result of merger from funds with lower funding levels. Some said liabilities should not be merged. Highland Council and Highland Council Pension Fund suggested a guarantee that employers not be exposed to deficits would be required from the Scottish Government. The Care Inspectorate – Scottish Social Services Council response suggested there should be a mechanism for redistributing funding from winners to compensate those who lose out. There should be consideration of how this mechanism could include admitted bodies.

Protection of local economies: Respondents said that mergers should explicitly mitigate any impacts on local economies. For instance, Shetland Island Council Pension Fund said mergers should be island proofed so the interests of the Shetlands were not harmed. Some responses suggested that local servicing arrangements be retained.

4. Analysis of respondents

The consultation was open to all constituents of the SLGPS, including members, employers, representative groups and organisations which administer the scheme – pension boards, committees and administering authorities. Due to limitations of the scope of the consultation:

- Employee representative groups were encouraged to respond on behalf of scheme employee members
- The consultation relied on administering authorities and councils to invite the participation of employers and admitted bodies.

Fifty six respondents were received to the consultation in 49 responses and a full list of respondents and their preferred option is given in Appendix 1.

Responses by type

This section provides an analysis of respondents categorised by type. To avoid confusion administering authorities are classified as 'Pension fund' when responding in their capacity as an administering authority while responses from councils in their separate capacity as employers are recorded as 'Local authority'.

Table 1: Responses categorised by type

Type	Number
Employer	19
Local authority	14
Pension fund[8]	11
Pension board	3
Pension committee	2
Charity employer representative	2
Employee representative	2
Professional services body	2
Employer representative	1
	56

Responses were received from all 11 pension funds (administering authorities) and 14 of Scotland's 32 local authorities in their capacity as employers. Three responses (Dumfries and Galloway; Lothian; Scottish Borders,) were received from pension boards, while two responses were received from pensions committees – one from the City of Edinburgh Pensions Committee and one from an individual member of the City of Edinburgh Pensions Committee.

The two responses from employee representatives were from national unions (Unison; Unite), while there were three responses from employer representatives; two representing charities (Robertson Trust; SCVO) and one representing councils (COSLA). Two responses were professional services bodies, representing 32 local authority finance directors (CIPFA

[8] Where councils have replied in their capacity as administering authorities they have been recorded as pension funds.

Scottish Local Authority Directors of Finance Section) and human resource personnel (Society of Personnel and Development Scotland).

Responses by location of members

This section provides an analysis of responses according to the location of the employees or employers represented by the respondent.

Table 2: Responses by member catchment

Catchment	Number
National	10
Strathclyde Pension Fund	10
Lothian Pension Fund	7
Tayside Pension Fund	7
Falkirk Council Pension Fund	4
Scottish Borders Pension Fund	4
Highland Council Pension Fund	3
Dumfries and Galloway Council Pension Fund	2
Fife Pension Fund	2
North East Scotland Pension Fund	2
Shetland Islands Council Pension Fund	2
Orkney Islands Pension Fund	1
NA	2
	56

The biggest fund by assets, Strathclyde, accounted for the largest catchment of 'local' responses with 10 responses.

Respondents representing employees or employers with multi-fund membership across the funds made up an equal sized group of respondents (10). As well as the employee and employer representative bodies mentioned earlier, responses were received from five employers (Audit Scotland; Police Scotland; Scottish Fire and Rescue Service; Scottish Police Authority; Scottish Water) which have members in multiple funds.

Responses by preference for option

Analysis of answers to Question 5 are presented in this section, in which respondents were asked which of the four options their organisation preferred for the future structure of the SLGPS. It should be noted that this quantitative data is presented for overview purposes and that the consultation reporting that follows is largely qualitative.

a) Response patterns

Some respondents worked together or were influenced by the responses of others and a brief overview of these influences is presented here.

1. Professional services bodies

The responses of the two local authority professional services bodies were influential and had an impact in many of the responses by pension funds, local authorities and pensions

boards. These in turn influenced the responses of many 'local' single-fund employers as described below.

The CIPFA Scottish Local Authority Directors of Finance Section was cited as an influence by respondents or was apparently influential, as measured by similarity of wording, in many responses by pensions funds, boards and local authorities. The membership of this organisation strongly overlaps with the personnel who would be expected to have a role in responding to the consultation – finance directors. The Society of Personnel and Development Scotland was cited as an influence, or was apparently influential, in some responses by local authorities.

2. Administering authorities

The responses of pension funds, local authorities, pension boards and employers within the same fund catchment were influenced by one another in most cases. Respondents sometimes prepared joint responses or endorsed the responses of others. So the preferences expressed for each of the four options for the future structure of the SLGPS tend to run along the lines of administering authority catchment areas, although not exclusively so. This was different for multi-fund employers, explained below.

3. Employers and employer representatives

Some employers provided joint responses when the respondents shared administrative functions. The charity employer representatives (Robertson Trust, SCVO) also provided a joint response.

b) Preference for option

Table 3: Preference for option

Option	Number
1: Status quo	13
2: Cooperation	23
3: Pooling	1
4: Merger	16
Not expressed	3
	56

Fifty three organisations expressed a preference, Audit Scotland, CIPFA and the individual member of the City of Edinburgh Pensions Committee gave no preference or expressly chose not to give one.

Option 1, maintaining the status quo, was preferred by 13 respondents although six of these respondents wished to include Option 2, cooperation, as a second preference.

Option 2, collaboration was the preference of the majority of respondents (23).[9]

[9] While the Highland Council Pension Fund Pensions Board supported Option 2, it wished to record that its board member representative from UNISON Western Isles (Local Government) Branch supports Option 4.

Nine out of 11 administering authorities preferred Option 1 or Option 2, that is, they preferred maintaining the status quo, or pursuing cooperation. Single-fund employers in these catchment areas also preferred options 1 or 2.

In a minority of responses there was some uncertainty whether Option 1 or Option 2 was preferred. We have made our best judgement in these instances. As noted by many respondents later in this paper, Option 2 may also reflect the status quo.

Option 3, pooling, was selected by one employee representative (Unite).

Option 4, merger, was selected by 16 respondents including two administering authorities (Lothian and Falkirk) as well as the majority (seven of nine) of the multi-fund employers and national employers representative groups who offered a preference (save COSLA, Option 2; and Unite Option 3). Single-fund employers attached to Lothian and Falkirk also tended to prefer Option 4, but not exclusively so.

Six of these wished to record Option 2, cooperation, as a second preference and two for Option 3, pooling.

In Option 4, five respondents (from employee representative, multi-fund employers and charity employer representative organisations) suggested merger of the SLGPS into a single fund, while seven respondents (including the Lothian and Falkirk administering authorities and local employers) suggested a merger into two or three large funds. One multi-fund employer, Scottish Water, expressed a preference for either a merger into a single fund or merger into two or three funds.

5. Arguments for and against the four options

This section provides consultees responses to questions about four options for the future structure of the SLGPS:

1. Retain the current structure with 11 funds.
2. Promote cooperation in investing and administration between the 11 funds.
3. Pool investments between the 11 funds.
4. Merge the 11 funds into one or more new funds.

For each option respondents were given four criteria on which to evaluate each option, some additional questions specific to each option, as well as an opportunity to make additional comments.

The criteria for each option and their justification for inclusion in the consultation terms of reference were:

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

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

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

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

The full set of questions and original consultation terms of reference can be found on SAB's website at lgpsab.scot/consultation2018.

This section also includes additional comments about each option that respondents offered when explaining their preference in Question 5 (a). It further contains responses to Question 5 (b) "What other options should be considered for the future structure…?" and (c) "What would be the advantages and disadvantages of these other options…?" as the respondents either said the options presented in the review were those available or provided comments that could be considered as variants on the existing options.

Notes on the quotation of responses

As noted in the analysis of respondents in Section 4, many respondents shared or endorsed responses. When responses are quoted directly in the analysis below, we have attempted to credit the original respondent but in some instances the respondent quoted may not be the original source. Where councils have replied as administering authority, we quote the full fund name (for example Falkirk Council Pension Fund rather than Falkirk Council) to avoid confusion in instances where there were separate responses both from councils as employers and funds as administering authorities.

We have also attributed quotes to only one respondent although other respondents may have responded using similar or verbatim text. We have edited some quotations for grammar or spelling.

Option 1: Retain the current structure with 11 funds

The first option presented to respondents was to maintain the status quo with 11 funds.

a) Cost of investing

Original questions:

- How well informed do you feel about the investment costs in your fund? What information do you rely on to specify and measure these?
- How well does the current system manage investment costs?
- How would you improve the measurement and management of investment costs in the current system?

What information do respondents rely on to measure investment costs?

Respondents cited a variety of public information sources, including fund accounts, pension board meetings, pension committee meetings, AGMs and bi-annual briefings

Several respondents cited the availability of additional information through private benchmarking exercises:

> Whilst annual investment reviews are undertaken independently and are not within the public realm, the fund officers provide presentations at regular employers' forums on fund performance and costs per accounts and against peer group. *Perth & Kinross Society for the Blind (VisionPK)*

> As a local employer we are able to attend the fund forums and question costs we fell are excessive. *Abertay Housing Association*

Some funds said they requested data required from investment managers. For example:

> Reports on underlying costs have in the past been presented to our Investment Sub Committee and if more information is required on costs, this is requested from Fund Managers. *Highland Council and Highland Council Pension Fund (Highland Group)*

How well informed do respondents feel about the investment costs?

Respondents gave their views on current fee disclosure arrangements and also new arrangements that are under development or being implemented.

1. *Existing fee disclosure arrangements*

Respondents were in less agreement on the quality of the information about fees currently available. For the most part, respondents believed administering authorities were good at sharing information about internal and external management costs.

Many acknowledged that there had been problems with the transparency of the fees charged by external fund managers, a key difference of opinion was on whether these had been resolved by new transparency measures:

> The investment costs are disclosed in the pension fund annual report and accounts in sufficient detail that stakeholders should be able to gain a good insight into the cost of managing the pension fund and its investments. *Orkney Island Council Pension Fund*

> The investment industry has not been entirely transparent in respect of costs, though there has been some improvement in recent years. *Strathclyde Pension Fund (SPF)*

> The transparency of fees remains a topic that the Council would welcome continued progress on and this remains on the agenda…. *North East Scotland Pension Fund (NESPF)*

Guidance published by the Chartered Institute of Public Finance and Accountancy (CIPFA) in 2014 and re-issued in 2016[10] and the introduction of the LGPS Code of Transparency was cited as improving the comparability and transparency of investment manager fees. For instance, several respondents, said they were well informed about costs of investing in the SLGPS because fund managers were signatories or had been encouraged to sign up to the LGPS code, or because administering authorities had adopted the CIPFA guidance.

But respondents had different levels of confidence on how well CIPFA guidance allowed for disclosure of 'hidden costs' in more complex asset classes:

> Cost information is requested from the Private equity and Property debt investment Managers which is included in the accounts. In order to comply with the CIPFA guidance, it is only costs that the Fund is liable for [directly] that are disclosed in the accounts and not underlying costs. *Highland Group*

> Fife Pension Fund comply with the accounting arrangements set out in CIPFA's guidance on Accounting for Local Government Pension schemes. However, there remain concerns around any "hidden" or "embedded costs" that are not disclosed as part of that process. *Fife Council and Fife Pension Fund*

> Strathclyde Pension Fund (SPF) has complied fully with the CIPFA guidance since publication in 2014. All investment management costs are recognised, measured and disclosed in the Fund Account in line with the guidance. This includes costs which are sometimes described as "hidden" and are not currently provided as standard by investment managers. Total disclosed expenses for SPF include management fees, management fees in pooled funds, performance fees, and transaction costs. *SPF*

> Lothian has been an advocate for investment cost transparency for a number of years to the extent that its financial statements have disclosed all costs since 2015, contrary to CIPFA accounting guidance. *Lothian Pension Fund executive, Lothian Pensions Board, Pensions Committee of City of Edinburgh (Lothian Group)*

Some respondents said existing transparency measures did not go far enough, being insufficiently granular and that producing comparable cost benchmarks required funds to incur significant costs and effort:

> Getting the full details of costs (management fees, transaction costs, foreign exchange and performance fees) is complex and requires staff to have the relevant knowledge and skills to obtain it. [Falkirk Council Pension Fund] is currently undertaking a cost benchmarking exercise, including an analysis of foreign exchange costs with Lothian Pension Fund using

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[10] *Accounting for Local Government Pension Scheme Management Expenses*

> the specialist expertise of Lothian's in house team. [The fund] is working towards having the performance objectives of its mandates measured on a net cost basis to allow more meaningful like-for-like comparison. At present, some mandates are measured gross of fees whilst others are measured net of fees. *Scottish Environment Protection Agency (SEPA)*

> …granular analysis of costs requires expertise both at the input and output stages and therefore has its own resourcing and cost implications. This is very much a live issue for funds. *Falkirk Council Pension Fund*

2. *New fee disclosure measures*

Several respondents suggested new measures being developed for the England and Wales LGPS and by the FCA would improve transparency.

> A more granular cost template covering most asset classes, including private equity and infrastructure, is currently being developed by the England and Wales Scheme Advisory Board and the Financial Conduct Authority and should improve cost transparency. *Falkirk Council Pension Fund*

> …at present the LGPS SAB cost transparency templates cover listed assets only for both segregated mandates and pooled funds (not private equity and property debt). These templates will be replaced during the next 12 months by templates designed by the Financial Conduct Authority's Institutional Disclosure Working Group, which are similar to those developed by the Scheme Advisory Board (SAB).

> The Scheme Advisory Board launched a "Code of Transparency Compliance System" tender in September for a system to validate / check for completion the templates received from the relevant fund managers for each of the relevant LGPS funds and or Pools (England and Wales). Subject to ongoing discussions with relevant parties and the SAB, the SLGPS funds may also be included in the final contract initially or at a later date….

> All our Fund Managers other than the private equity manager provide us with completed cost transparency templates on an annual basis. The Fund's private equity manager is actively involved in discussions to produce the cost transparency template for private markets. *Highland Group*

How well does the SLGPS manage investment costs?

Respondents referred to the following elements when giving views on how well the SLGPS manages investment costs:

1. What existing investment cost data shows
2. The presence or absence of a competitive market for investment management in the UK
3. Administrative elements of the SLGPS that could control costs

1. *What existing SLGPS investment cost data shows*

Responses included analysis of problems with existing cost reporting; focusing on net returns; or using other measures as a proxy for costs.

Some responses felt that investment costs reported under current CIPFA guidelines lacked consistency and the SLGPS as a whole underreported costs as a result:

> Directly comparable data on investment costs from individual funds is lacking and this has hindered previous reviews of the SLGPS structure. While all funds would undoubtedly support

investment cost transparency and are subject to scrutiny through published audit exercises, the lack of consistency of information from investment managers makes it difficult for employers and other stakeholders to judge the effectiveness or efficiency of the scheme as a whole. *Scottish Water*

Despite the evolution of framework agreements and benchmarking arrangements, there is still no central and easily accessible resource that discloses the full range of investment mandates and fees charged to the LGPS that would allow funds to shop around for the best fees. *Orkney Islands Council Pension Fund*

We assume that Administrators follow CIPFA guidance ("Accounting For Local Government Pension Scheme Management Costs") to promote transparency of investment management fees. However how these are decided is not clear, in terms of how these are decided and how much competition they are exposed to. *Scottish Fire and Rescue Service*

We also acknowledge the UK pension industry-wide debate on the lack of transparency and reporting on investment costs, particularly those associated with external investment managers which impacts the comparability across LGPS funds. *Police Scotland–Scottish Police Authority (Police Scotland)*

The implementation of the LGPS SAB cost transparency database will help to ensure there is consistency in reporting fees across all Funds and this can be used to compare fee levels being charged by the same Manager. *Highland Group*

Cost reporting lacks transparency and consistency. Lack of transparency of investment costs is a national (UK) and industry-wide issue. Lothian has previously written to CIPFA Pensions Panel to highlight the lack of transparency in LGPS financial statements. The lack of transparency and inconsistency of reporting between funds makes evidencing and managing costs difficult across the SLGPS. Full investment costs of SLGPS are generally not disclosed in financial statements, particularly where there are layers of fees e.g. fund-of-fund arrangements. The lack of transparency of investment fees and general lack of comparability of other aspects of the SLGPS hinders policymakers.

Current CIPFA standards under-report costs. The following table shows the significant difference in fees disclosed in financial statements for 2014/15 as a percentage of assets, when CIPFA guidance reversed disclosure, for the largest three SLGPS funds. It shows that the reversed disclosure significantly understates fees.

	Investment Fees for 2014/15 as % of Assets			
	Original (full) disclosure	**Revised (partial) disclosure**	**Difference**	**Original vs Revised disclosure**
Strathclyde Pension Fund	0.80%	0.57%	0.23%	+40%
Lothian Pension Fund	0.50%	0.50%	-	-
North East Pension Fund	0.57%	0.42%	0.15%	+36%

Under-reported SLGPS costs are c£70m - £80m per annum. For 2017/18, SLGPS investment fees (representing 90%+ of total management fees) shown in financial statements were £207.8million (approximately 0.47% of investments). As the above table illustrates, this is significantly under-reported due to CIPFA guidance. If the under- reporting is consistent with 2014/15, fees of c£200m could be under-reported by 35%- 40% per year, equivalent to between £70m - £80million per year. *Lothian Group*

Some respondents said fees should be analysed in relation to the benefits they returned. For example:

> The absolute level of cost is not however necessarily the most important factor. Limiting fees is an important consideration in improving investment performance, however paying additional fees to deliver out performance through active management of pension fund investment is an equally important consideration. *CIPFA*

> The key issue is not however the level of fees charged but the net benefits delivered through manager out performance and having a clear understanding of the costs associated with this. The Board believes that the overall value for money delivered by a manager is a more important consideration than crude investment costs. *Scottish Borders Council Pension Board*

> Investment management costs for the Orkney Islands Council Fund, when viewed in isolation, have increased over recent years as the investment strategy has been developed and investment mandates have changed with the fund managers seeking higher fees commensurate with the more complex investment strategies. The investment costs are however only a part of the consideration and performance net of costs is the real measure of the value added by investment managers. *Orkney Islands Council Pension Fund*

> There is little evidence to support the notion that higher costs lead to higher net returns. *Lothian Group*

Several respondents suggested that different measures of the SLGPS could be used to infer costs are well managed or that cost transparency was unrelated to structure:

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

> Fund liabilities are generally 85-90% funded suggesting [they are] prudently managed. *Society of Personnel and Development Scotland (SPDS)*

> The costs of administering the scheme in Scotland are relatively low and stable. There is some variation in the level of administration cost between funds which may be a result of different level of fee disclosure. C*IPFA Scottish Local Authority Directors of Finance Section (CIPFA)*

> Whilst acknowledging the current cost transparency shortcomings, this is not attributable to the current structure within the LGPS, although larger Funds certainly have more resources to focus on this area. *Falkirk Council Pension Fund*

2. Competitive investment management market

Many respondents pointed out that the competitiveness of the UK investment management played a role in delivering lower costs, a key point of difference was how competitive the market was.

Several respondents reported that reforms to the local government pension system in England and Wales had improved market competition and aided the management of costs in Scotland. For example:

> SLGPS Funds have benefitted from the pooling in England and Wales …some Fund Managers have proposed lower fee rates on a consistent basis across Funds. *Highland Group*

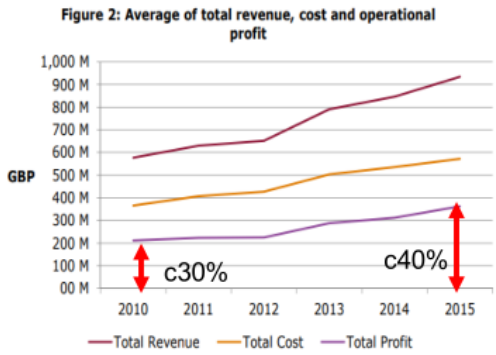
Respondents disagreed on the interpretation of the FCA's *Asset Management Market Study* published in 2017.

Some respondents interpret this report's findings of weak price competition in UK asset management as applying only to small – retail – investors and thus the study findings support the view that SLGPS costs are well managed. Other respondents say the findings of weak price competition also apply to SLGPS funds.

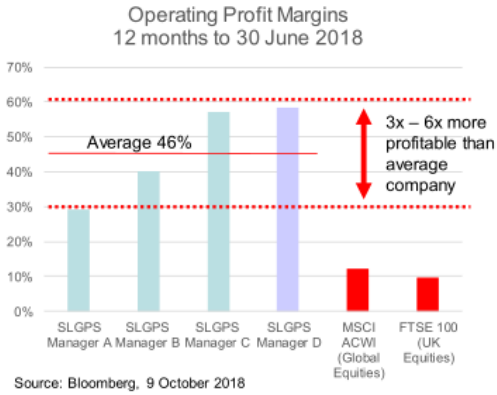
> The Financial Conduct Authority's (FCA) recent final report on its Asset Management Market Study, which is referred to in the Scheme Advisory Board (SAB) structural review report, highlights a number of weaknesses in the current asset management system in the UK. These include weak price competition, a lack of transparency, and a lack of alignment of fees and performance. These issues apply particularly to small, retail investors. (There are 33,000 DC pension schemes in the UK with less than 11 members.) The report confirmed that large institutional investors are able to negotiate very effectively and get good value for money. In this context, Local Government Pension Scheme funds are all large investors. SPF

> SLGPS is paying significant profits to external asset managers. Asset management is a highly profitable industry. This is evident in the FCA's 2017 Asset Management Market Study which found that there was: weak price competition; lack of alignment between performance and costs; a lack of cost awareness amongst some investors. The FCA study showed asset managers achieving average operating profit margins of 30% - 40% from 2010–15. Our own analysis of profit margins for four listed asset managers (within the top 10 SLGPS external managers) at 30 June 2018, showed average profit margins of c46%. Asset manager profit margins are between three to six times more profitable than the average company supporting the FCA's finding that there is weak price competition in the industry

> The majority of the c£208m in SLGPS investment costs is paid to external asset managers. Assuming an average profit margin of between 30% - 45%, the SLGPS is paying out £60m to £95m in profits to the asset management industry on an annual basis. *Lothian Group*



Source: FCA Asset Management Market Study Interim Report (Nov 2016) - Annex 8, pg 9



Source: Bloomberg, 9 October 2018

3. *Administrative control of costs*

Comments were made on institutional arrangements to control costs and the role of size in controlling costs.

Many respondents said the institutional arrangements designed to control fees and encourage competition in procurement were effective in managing costs. These included active reviews of fund manager contracts, public procurement processes and the ability of pension funds as large investors to get good value for money. For example:

> The Council view is that investments are well managed, with time and resource being allocated to ensure this is being carried out robustly….there is a continued review and negotiation of fee savings as part of the ongoing investment strategy, with Asset and Investment Manager Performance reported to our Pensions Committee and Pension Board quarterly for scrutiny. *Aberdeen City Council*

> Local Government Pension Scheme (LGPS) funds are all large investors and as a large institutional investors SPF is able to negotiate very effectively and get good value for money. *East Ayrshire Council*

> All LGPS investment services are subject to tender, and in addition to the requirements to meet public sector procurement guidance, there is additional scrutiny through the governance framework and public accountability from members and employers. Whilst there is always room for improvement, it is clear that within this industry, LGPS are subject to greater levels of scrutiny and transparency to their corporate counterparts. *Tayside Pension Fund*

> The fund employs competitive tendering in the procurement of investment managers investment advisors, tax advice, custodian services and for actuarial services thereby ensuring best value is delivered. *Scottish Borders Council Pension Fund*

> Investment costs are discussed with investment consultants at the initial outset of an investment strategy review project. When interviewing prospective fund managers during a tender for a new mandate, the fund managers are questioned on their investment costs using the competitive situation to try and reduce costs. *Shetland Islands Council Pension Fund*

> The current system allows robust management of these costs. Practice in this area is evolving. Pension administrators need to build fee transparency requirements into their investment manager appointment process, actively manage contracts and provide regular management information to their committees and boards. The current system allows for all of these activities. *SEPA*

> Collaboration (and the aligning of strategies) should allow the negotiation of better rates from asset managers and partly address some of the issues raised by the FCA. The structure of the LGPS with its accountability to local Committees and Boards should allow there to be a strong regime of oversight, however this depends on the ability to obtain meaningful cost information. The templates should assist with this. The procurement regime within local government means that there is a focus on best value and fees in any manager tendering process. *Falkirk Council Pension Fund*

However other respondents suggested the ability to manage costs is linked to the size of each fund. In this view, larger funds had more resources to control costs, including the ability to manage funds in house, and could also command better prices due to their larger scale. For example:

> Fee levels are of importance to all pension funds however, particularly for smaller funds there are limited resources and experience to manage and challenge investment costs or to analyse in depth. Larger funds may be better equipped to actively manage costs. Consideration also needs to be given to the level of performance achieved for those costs. *Fife Council and Fife Pension Fund*

> … the lack of consistency of information from investment managers makes it difficult for employers and other stakeholders to judge the effectiveness or efficiency of the Scheme ….the strongly held suspicion is that the current structure is inefficient. Investment benefits from scale and broadly speaking, larger funds can achieve lower fees while having access to greater investment opportunities. The combined SLGPS is smaller than some of the largest UK pension funds and pales in comparison to the biggest funds on the international pension stage, where fund sizes equivalent to hundreds of billions of pounds are common. Possibly with the exception of Strathclyde Pension Fund (c£21 billion), all other SLGPS funds could benefit from greater scale. *Scottish Water*

> In-house management is a cost-effective option. Lothian is the only fund within SLGPS that manages investments internally. At 31 March 2018, the team managed c68% of LPF's assets on a direct basis, with an in-house investment expense ratio of 0.09%. The ratio of 0.09% is 80% lower than the ex-Lothian SLGPS investment expense ratio of 0.47%. The annual savings from applying the in-house ratio to ex-Lothian SLGPS assets would be c£70m pa.

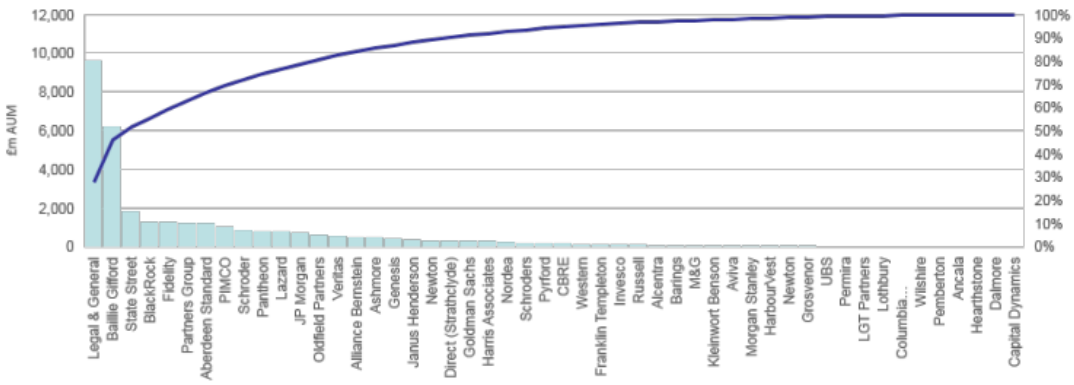
This figure is within the range of the estimated £65m - £90m being paid out in external manager profits….

The chart below shows the total SLGPS assets managed by external investment managers as at 31 March 2018 (left hand axis) and the cumulative proportion (right hand axis). The graph shows:

- two managers (Legal & General and Baillie Gifford) manage approximately half of SLGPS assets managed externally;

- ten managers manage approximately 70% of the externally managed SLGPS assets;

- there are over 52 external investment managers named in the funds' financial statements. This is a significant underestimate due a number of managers being manager-of-managers (e.g. Partners group, Schroder, Strathclyde Direct, Capital Dynamics).



How could the SLGPS improve the measurement and management of costs?

Some responses suggested previous reforms were sufficient or required time to bed in; others suggested changes to reporting measures.

A minority of respondents believed the current arrangements were sufficient or required further time to bed in:

> The competitiveness in the fund management industry has brought down costs over the past few years and the Code of Transparency is increasing the disclosure of costs, these measures by themselves are improving the measurement and management of investment costs. *Shetland Islands Council Pension Fund*

> There are no significant weaknesses in the current arrangements. *Comhairle nan Eilean Siar*

Many respondents believed the SLGPS could improve measurement and management of costs, including making current best practices into mandatory requirements; cost benchmarking using the SAB data base against SLGPS and other pension funds, contract service performance reporting; and reforms to reporting requirements.

> There is a significant opportunity to improve the measurement and management of investment costs through a requirement for LGPS funds to implement consistent and transparent reporting of investment fees and engage with the industry cost benchmarking exercise. *Police Scotland*

> The lack of consistency of reporting (including investment fees) of funds hinders policymakers overseeing the Scheme. Such transparency should also improve decision making of the

individual funds. Consideration should be given to compulsory reporting, with appropriate oversight, to improve governance of the SLGPS in the future. *Lothian Group*

Make the implementation of CIPFA guidelines, the LGPS Code of Transparency and MiFID II rules mandatory rather than best practices:

Ensure that all funds must adhere to various sector best practice arrangements (e.g. the CIPFA guidance, the Transparency Code 2016, MiFID 11 (the Markets in Financial Instruments Directive) and Financial Conduct Authority directions) and demonstrate they are doing so. *Scottish Fire and Rescue Service (Scottish Fire)*

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

Adopt the FCA's Institutional Disclosure Working Group's recommendations standard templates for data collection and make these requirements for fund manager procurement:

The FCA report proposes a package of remedies including strengthening the duty on fund managers to act in the best interests of investors, consistent and standardised disclosure of costs and charges to institutional investors, and proposals to improve the effectiveness of intermediaries. SPF would support these measures, albeit they are addressed more towards smaller investors. *SPF*

A recommendation of the 2017 FCA report was that asset managers should provide a consistent and standardised disclosure of costs and charges to institutional investors….the Institutional Disclosure Working Group…made the following recommendations:

- the use of templates for the collection and analysis of manager data,
- institutional investors to press managers to comply, with non-compliance resulting in de-selection from appointment short lists and the non-renewal of contracts,
- adoption of the standards by investment consultants,
- greater investment cost education of institutional investors,
- proposals to be encouraged by investment industry rep organisations,
- progress to be reviewed within one year of launch. *Falkirk Council Pension Fund*

Transparent benchmarking of costs between SLGPS funds assisted by the SAB:

With the proviso that the LGPS SAB cost transparency database is successfully implemented, this will act as a check on the consistency of fee information. The fee data can then be used to complete meaningful comparisons in order to achieve best value for all LGPS pension funds. *Highland Group*

Following on from the development of the Code of Transparency and the disclosure templates, there may be a role for the Scheme Advisory Board to collate and publish an analysis of the investment costs of the different investment mandates being followed by the 11 Administering Authorities. *Orkney Islands Council Pension Fund*

Work by the FCA's Institutional Disclosure Working Group, with the backing of the English & Welsh LGPS Scheme Advisory Board, and the introduction of standard templates for cost disclosure should improve cost transparency. The SLGPS Scheme Advisory Board should also compel funds to obtain and disclose this information and to participate in cost benchmarking. *Lothian Group*

Cost benchmarking with funds outside the SLGPS:

While benchmarking of investment management costs is provided against other Scottish LGPS Funds, providing a benchmark against other organisations managing large amounts of investments (ie other non-LGPS pension funds) would be helpful. *Care Inspectorate–Scottish Social Services Council (CI-SSSC)*

The sharing of detailed information on fee rates per managers across all funds in England, Wales and Scotland would allow clear comparison of rates and aid funds in their discussion with Managers. *Scottish Borders Council Pension Fund*

Improve contract service reporting:

The current system allows fund managers to get sight of all elements of fees / transaction costs through the procurement and appointment process: this information should be included in the specification of services required and it should be monitored through normal contract management channels and through the committee and board scrutiny of investment performance. There could be improvement in practice of how the funds manage investment managers and report contract service performance to committees and boards. *SEPA*

Reform CIPFA reporting guidelines:

Some cost information is disclosed in the Falkirk Fund's accounts but there is a need for accounting bodies to be more certain in relation to their disclosure requirements. (Recent years has seen disclosure range from including hidden costs to excluding them). *Falkirk Council Pension Fund*

CIPFA reporting standards should also be amended to ensure disclosure of full costs in funds' financial statements and investment performance, both net and gross of fees. *Lothian Group*

Provide more resources to improve reporting, move fund management in house and benchmark internal managers:

At a global level, we note that best practice is for larger funds to manage more of their assets in-house with less reliance on external investment managers and the higher costs associated with this. *Police Scotland*

Funds should be resourced accordingly to undertake such granular analysis of costs (see comments below on resource. *Lothian Group*

Funds should not lose sight of internal management costs, a format and approach to what is considered internal management costs should be developed in a similar fashion as the template for external mangers costs. *SEPA*

b) Governance

Original questions

- How well informed do you feel about the governance of your fund? What information do you rely on to measure this?
- How well is the current system governed?
- How would you improve governance of the current system?
- How important is it to maintain a local connection with respect to oversight and strategy? How would you determine if the benefits of a local connection in governance outweigh the benefits of scale?

What information do respondents rely on to judge the governance of their funds?

Respondents listed a variety of public sources of information published by funds they use to evaluate the governance of the SLGPS including annual reports; AGMs; published governance policies, the governance sections of fund websites; and minutes of pension and board committee meetings.

Several respondents mentioned information published as part of the requirements of the Public Services Pensions Act 2013 and later legislation: annual governance statements, governance compliance statements, statements of investment principles and funding strategy statements.

Respondents also used information from internal audit processes, administering authority pension subcommittees and executive officers of the funds.

A range of external measures were also cited including actuaries reports, advice from investment consultants, investment custodians, corporate social responsibility advisors, external benchmarking exercises, external audits, Audit Scotland reports, the reports of board training programmes, and compliance-reporting against CIPFA Myners guidelines.

How well informed do respondents feel about the governance of funds?

Based on the above, respondents felt they were well informed about the governance of funds in the SLGPS. However, some employers said they found participation difficult:

> Our ability to actively participate in the governance of each of the funds is restricted as a multi fund employer. We currently have employer representation on the Pension Board of one fund, Lothian Pension Fund. *Police Scotland*
>
> …we rely on communications from the administrators, however we are aware that further information is available on fund websites. *Scottish Fire*
>
> The current system is well governed although it would be time consuming for stakeholders to keep on top of complex pension issues. *Children's Hearings Scotland*

How well do respondents feel the SLGPS is governed?

Respondents referred to the following elements when giving views on how well the SLGPS is governed:

1. Existing arrangements as evidence of good governance
2. Impact of multiple governance systems
3. Administration by local authorities.

1. Existing arrangements as evidence of good governance

Respondents felt that the SLGPS was well governed because of compliance with existing arrangements; they were consulted by funds; external audits; the KPMG review; and training measures.

Compliance with current legislative and reporting requirements, including the Public Service Pensions Act 2013, MiFID II and CIPFA Myners Principles:

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

> All 11 administering authorities demonstrate high levels of compliance with good governance standards as exemplified by the Myners Principles. *CIPFA*

> The fund also measures its compliance against the Myners principles which reflect best practice guidance issued by CIPFA covering the effectiveness of decision making, the setting of clear objectives for the fund, the understanding of risks and liabilities, performance assessment, responsible ownership, transparency and reporting. *Scottish Borders Council Pension Fund*

> The current governance structure complies with the requirements introduced in the Public Service Pensions Act 2013. The Pensions Committee and Board sit jointly on a quarterly basis which allows for greater scrutiny of decisions. Strong attendance at both meetings and training events, in addition to strong engagement demonstrates our commitment to good governance. *Aberdeen City Council*

> Due to the regulatory framework that all LGPS funds must comply with there is a robust system of governance in place. *Highland Group*

> The recent advent of Pension Boards, with local employee membership, has added a further positive dimension to the governance of the pension fund. *Scottish Borders Council Pension Fund*

> It is understood that all funds and Councils as employer bodies have opted up to "professional status" to comply with the requirement of MiFID 2. *Scottish Borders Council*

> The fund has successfully opted up to Elective Professional Client status under MIFID II with all relative parties, thereby demonstrating that the required governance requirements are met *Dumfries & Galloway Council Pension Fund*

Consultation of member employees by administering authorities:

> The governance structure of the Fund works well and as an employer member we are actively engaged and consulted with regards the operation, performance and development of the Fund…The Council has active involvement in investment strategy, governance and stakeholder engagement through elected member representation on the Pension Fund Board. *Renfrewshire Council*

External audit reports from Audit Scotland:

> The SBCPF is audited on an annual basis by Audit Scotland. The 2017/18 audit of the pension fund concluded positively on the governance of the fund noting "the fund has effective governance arrangements in place that support the scrutiny of decisions made by the pension fund committee." *Scottish Borders Council Pension Fund*

> Statutory external Audit of the LGPS funds is undertaken annually. These do not highlight any concerns with the current governance arrangements in place across funds. *CIPFA*

> In recent years there has been significant improvement in the External Audit reports and the most recent report was a very positive report with a few achievable recommendations and actions. *Fife Council and Fife Pension Fund*

KPMG 2016 review:[11]

> In 2016 KPMG undertook a review of the governance of the LGPS. The outcome of that review was very positive. The study outlined that effective compliance with the principles of good governance is largely already in place across the LGPS in Scotland. *CIPFA*

> The review's findings overall were positive and no fundamental weaknesses were identified, though KPMG made a number of recommendations addressed at helping the new Boards establish their purpose. *Tayside Pension Fund*

> In our opinion, the current system is working extremely well. However we acknowledge that the governance review carried out by KPMG…identified small areas for potential further improvement to be addressed. *Aberdeen City Council*

Competency guidelines and training programmes:

> The current system of governance with its committee and board structure is robust. Governance practice requires [Falkirk Pension Fund] committee and board members to have appropriate skills and competencies to undertake their roles. On-going professional development is required to keep abreast of changes in pensions administration and the investment environment. *SEPA*

> Hymans completed a study of Pension Funds which asked for Members to assess their confidence regarding a number of areas including Pensions Governance. The results for the Fund will be incorporated into future training events in 2019. *Highland Group*

2. *Impact of multiple governance structures*

Respondents were divided on the impact of each fund operating its own governance structures.

Some responses suggested bespoke implementation of governance created inefficiencies, led to skill gaps, overreliance on advisors and made the system's performance difficult to evaluate. Multi-fund employers found it difficult to manage their involvement with multiple funds:

> …governance of the SLGPS is also inefficient in terms of the resources currently required. In the region of 150-180 people are involved in the pensions committees and pension boards across Scotland, many with limited knowledge and experience of pension matters despite the best efforts of funds to provide appropriate training. *Scottish Water*

> Members of the pension board take on this role voluntarily, do the work alongside their other work/union duties and usually have little or no pensions expertise. Lothian's Pension Board has experienced frequent turnover in and has had vacancies on a regular basis. *Lothian Group*

> The governance of the current system has significant weaknesses. Whilst each fund is subject to scrutiny through its own governance and audit, there is a lack of consistency in the available information that makes it difficult for stakeholders and the Scheme Advisory Board to judge the effectiveness of the Scheme as a whole. *Lothian Group*

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[11] *Scottish Public Service Pensions Governance Review,* KPMG, February 2017 was commissioned in 2016 by the Scottish Public Pensions Agency to comply with the Pension Fund Regulations 2015.

> Our ability to actively participate in the governance of each of the funds is restricted as a multi fund employer. We currently have employer representation on the Pension Board of one fund, Lothian Pension Fund…We recognise that the governance structures and the level of involvement from employers, particularly non local authority bodies, can vary amongst funds. This highlights a lack of commonality and ability to seek appropriate assurance on the overall effectiveness of the LGPS in Scotland. *Police Scotland*

> The Committee makes decision around the investment strategy for the fund, relying significantly on external investment advisers. There are questions around whether pension fund management is a core function of the Council? *Fife Council and Fife Pension Fund*

> There are significant key person risks and funds generally lack internal resource. As a result, funds are heavily and unduly reliant on external suppliers, particularly for investment services. *Lothian Group*

Others suggested that skills issues had been resolved and the duplication was necessary to ensure local stakeholder involvement in the funds:

> Although some of the people involved at the beginning had limited knowledge and experience of pension matters, the officers, advisors and experienced members of Committees have provided support and guidance. Abertay University believe that the introduction of pensions boards in addition to pension committees has improved the scrutiny and communication of the fund with its stakeholders. *Abertay University*

> Although some believe the governance of the SLGPS to be inefficient, due to the volumes of people across the country involved in the Pensions Committee and Pension Boards, this was the structure designed by the UK Government to support close ties with stakeholders…*Tayside Pension Fund*

3. *Administration by local authorities*

Some respondents said that the nature of councils as administering authorities and participants within the fund was problematic for governance; others said that these issues were mitigated by existing governance arrangements.

Administering authorities were said to have a greater say in governance because their ex officio positions granted them the majority of seats on boards

> …the lead Council must have a majority of seats on the Pensions Committee which curbs the scope for representation from other employers. There has been an improvement in oversight with the establishment of Pension Boards…. The last decade has seen some extension of member and employer representation within the governance structure, although the extent of the representation remains variable across Funds and at the discretion of the lead Council. *Falkirk Council Pension Fund*

> Local Government regulations (Local Government Act 1973) restrict representation and…the majority of SLGPS Pension Fund Committees comprise solely of councillors from the Administering Authority. *Lothian Group*

The presence of elected councillors was cited as hindering governance because of time pressures, electoral turnover and skilling:

> .. overall governance is weakened by the time pressures on elected members (given all their other responsibilities); the potential for member turnover due to the electoral cycle; and capacity for members to absorb the wide range of complex pensions matters requiring consideration. *Falkirk Council Pension Fund*

> …elected committee members who may only have been through a single fund valuation cycle, can find themselves unelected and replaced with new members who have to start learning about pensions from scratch. *Scottish Water*

Some respondents highlighted fiduciary conflicts between local authorities as employers and as administering authorities:

> Both officers and elected members have conflicts of interest, for example, with councillors and officers being responsible for setting employer contribution rates for the pension fund as well as managing council's finances. *Lothian Group*

> It is a fact that while the involvement of Councils as administering authorities for SLGPS funds allows for some local accountability in fund decision making, this does also bring governance issues in the form of potential conflicts of interest for elected members and fund officers. *Scottish Water*

> The current model of a managing authority, one of whose committees effectively runs a scheme with multiple employers (some of whom are themselves local authorities) is no longer fit for purpose. It leads to:
>
> - confusion on behalf of the public who think that it's an investment fund owned by the council
> - confusion by councillors who also think that it's an investment fund owned by the council
> - a refusal by some councillors to recognise that it is not an investment fund owned by the council and hence to abjure their fiduciary duty
> - inappropriate application of council policies and procedures. … Earlier this year [Lothian Pension Fund] sought to appoint a new [Independent Professional Observer]. Despite it clearly being an appointment process, the procurement staff of [City of Edinburgh Council] insisted on treating it as a matter of purchasing a service as if it was office cleaning. They also fiercely resisted any involvement by committee or board members. It took a great deal of time and effort from many of us to get the process amended.
> - an inability to have the necessary resources or systems in place because the standard approach of CEC does not meet our needs. The most concerning of which is our inability to get the level of IT support and security that we require. This is a very significant element of our risk register as it could adversely affect our FCA authorisations. *John Anzani, member, Pensions Committee of City of Edinburgh*

> Consistent feedback from third sector participants in LGPS highlights poor clarity in communication, a lack of focus on these organisations' specific circumstances, limited flexibility when considering exits from the Fund and an inequity in dealing with legacy liabilities, relating to public sector employers, accrued in the Funds. These findings are wholly consistent with those recently identified as part of the Tier 3 review commissioned by the Scheme Advisory Board in England & Wales. *Robertson Trust–SCVO (Robertson Group)*

Others acknowledged the existence of concerns about the role of councils but had seen no evidence of conflict of interest and believed existing governance arrangements mitigated these issues. For example,

> [Dundee City Council] is aware that statements have been made regarding councils acting as administering authorities bring governance issues including limited involvement of stakeholders and conflicts of interest for both officer and elected members. [The council] believe that there is no evidence of this and furthermore believe that [Tayside Pension Fund] (as well as all other Scottish funds) have appropriate policies and controls in place to prevent this. *Dundee City Council*

How would respondents improve governance of the SLGPS?

Respondents made suggestions in the following areas on improving governance of the SLGPS:

1. Improving skills
2. Transparency and benchmarking
3. Improving the ability of pension boards and committees to oversee funds
4. Financial independence of funds and single fund for national employers

1. Improving skills

Several respondents suggested identifying and remedying gaps in the skills of key personnel involved in the scheme as a means of improving governance.

Some respondents suggested that ongoing professional development or mandatory training measures should be introduced for pension board and committee members: trustee toolkits from the FCA and The Pensions Regulator were recommended.

Others some said that the Transparency Code, pensions boards and recommendations in the KPMG 2016 review should be more fully implemented by funds or given more time to bed in:

> Recommendations from the KPMG review should continue to be worked through and implemented. *SPF*
>
> Recommendations of Scottish Government's review of governance arrangements (undertaken in 2016 by KPMG), should be implemented, particularly around clarifying roles and responsibilities and training for both the Scheme Advisory Board and Pension Boards. *Lothian Group*
>
> The [KPMG] findings recommended improvements in training and guidance for Boards in order to ensure that their focus was on their oversight role. This clearly chimes with the importance of all those charged with governance (Committees, SAB and Local Boards) having the requisite skills and knowledge. *Falkirk Council Pension Fund*
>
> These arrangements need to be given time to bed in although they have improved employee representation and would appear to be to be working effectively. It would seem too early to consider making further changes to the current arrangements without the necessary data to understand how effective still relatively new governance changes have been. *Argyll and Bute Council*
>
> The introduction of Pension Fund Boards is fairly new and will take time to settle down. *Fife Council and Fife Pension Fund*
>
> Significant changes to the pension scheme were introduced in 2015 along with new, improved governance arrangements – these need time to properly enable evaluation of the effectiveness of change – there have been some positive signs of enhanced governance with greater and more effective employee/employer representation in funds. *East Lothian Council*

2. Transparency and benchmarking

Respondents suggested governance could be improved by: ongoing monitoring of best practice; regular governance reviews; outside audits; sharing of experience between fund

pensions boards; greater public sharing of fund policies; and proactive SAB measures. For example:

> The Governance of the current system is believed to be strong but perhaps a national overview report by Audit Scotland highlighting areas where improvements could be made by individual funds would be beneficial. *Orkney Islands Council Pension Fund*

> All funds should be required to publish information regarding their investment strategy, actuarial report and funding assumptions as well as performance and key policy documents for example the statement of investment principles or their [environmental, social and governance] policies. Pension Fund committees should meet jointly with Pension Boards on a regular basis and committee meetings should be held in public wherever possible…. the Fund believes a strong proactive Scheme Advisory Board has the potential to ensure all funds are fully meeting the required standards of governance and oversight. *Scottish Borders Council Pension Fund*

3. *Improving the ability of pension boards and committees to oversee funds*

Responses suggested pension boards and committees could be given greater ability to provide oversight, including clearer roles in legislation and more independent board members.

Changes to legislation to clarify the roles of the pensions committee and the pension board were suggested:

> Lothian has, for many years, invited and welcomed the involvement of members and employers in the governance of the Fund, through its Consultative Panel …Regulations confuse the scrutiny role (which the Pension Board is required to undertaken by the Public Sector Pensions Act on behalf of the Pensions Regulator) and the Committee's mechanism of consulting with employers and members in day-to-day governance. Lothian believes the two roles should be more distinct. If employers and members had representation in the fund's governance, the Pension Board could focus purely on its scrutiny role. Committees and Boards would benefit from membership with greater expertise. *Lothian Group*

> …the scheme of governance is altered so that the pensions committee is not a committee of a local authority. *John Anzani, member, Pensions Committee of City of Edinburgh*

> …the Board does not have voting or decision making ability. This could be reviewed to allow the Board to have more capabilities. *Shetland Islands Council*

> Under the current governance structure, there should be mandatory member and employer representation on Pensions Committees. Committees and Boards would benefit from membership with greater expertise. Independent Professional Observers could be made mandatory. *Lothian Group*

Many suggestions focused on increasing independent - or non-administering authority - representation on boards:

> It would improve membership of the committee if there were more members who are not councillors, for example an additional pensioners' representative and or deferred pensioners' representative, and less councillors. This would provide continuity and allow the development of a depth of knowledge across all pensions' matters. *SEPA*

> I would also recommend that even if the majority of members of the pension committee are councillors there should be a minimum of one member representative and one employer representative as full voting members. *John Anzani, member, Pensions Committee of City of Edinburgh*

> Make employer and member representation on Committees mandatory but allow the lead Council to maintain a majority. Require committees to have an independent trustee-cum-advisor. *Falkirk Council Pension Fund*

> As an employer/Council who is not the administering authority, we have significantly less ability to exert appropriate and proportionate influence…we would promote breaking the current dominance of the administering authority ensuring that member councils/smaller employers are given a proportionate voice. *East Lothian Council*

4. *Financial independence of funds and single fund for multi-fund employers*

There were suggestions for greater separation of the governance and the executive of funds from councils, including resourcing funds separately from local authorities, and transferring the members of national employers into a single fund.

> There should be a Section 95 officer for the pension funds, distinct from that for the Administering Authority. The pension fund should have a distinct budget and resource, (to avoid Council's financial constraints being inappropriately being applied to the pension fund) with agreements in place for any costs/services paid to/received from the council. (It should be noted that the English & Welsh LGPS are currently reviewing the potential separation of the pension fund from the administering authority and lessons could be drawn from that review). *Lothian Group*[12]

> A bespoke governance structure, distinct from the current administering authority model, would facilitate better management of conflicts of interest and facilitate wider involvement of stakeholders (including members of the fund, representatives from councils and other employers which are not currently administering authorities). *Lothian Group*

> ..the needs of the Pension Fund are not always aligned with those of the Administering Authority or Other Fund Employers (e.g. the Fund may need to recruit at times of a wider Council recruitment freeze). *Falkirk Council Pension Fund*

> For employers who have members in more than one SLGPS, options to consolidate membership into one fund should be promoted. *Lothian Group*

How important do respondents feel it is for funds to maintain a local connection with respect to oversight and strategy?

Responses covered the impact of the connection between funds and local stakeholders; how a local model affected multi-fund employers; and varying practices.

1. *Impact of the connection between funds and local stakeholders*

Respondents commented on a local connection in relation to demographics, democratic accountability, locating investment strategy with contributions, and local participation in governance.

Democratic accountability to taxpayers was cited as reason of a local connection. For example:

> …asset allocation strategy is informed by the risk appetite of the committee and its investment policies - for example with regards to environmental considerations. It is important that these decisions are kept as local as possible so that elected representative on decision

[12] Section 95 of the Local Government (Scotland) Act 1973 requires local authorities to make arrangements for the proper administration of their financial affairs and appoint a CFO to have responsibility for those arrangements.

> making bodies can be held accountable to their members and the local electorate for their decisions with regard to oversight and strategy of the pension fund. *CIPFA*

> The local connection is important for democratic accountability as the scheme and the funds are supported by local taxpayers. *Falkirk Council Pension Fund*

> Decisions with regard to investments, ethical investment, environmental issues, risk management etc. should kept as local as possible so that elected representatives can be held responsible to their members and the local electorate for their decisions with regard to oversight and strategy, and ultimately, their stewardship of the pension fund. *Scottish Borders Council Pension Fund*

Some commentators suggested that democratic accountability had already been lost for councils who were not administering authorities, or because decisions were made executively:

> Democratic accountability is important as the majority of members of the SLGPS are council staff and…costs are paid by council taxpayers. However, only 11 out of the 32 Scottish councils are administering authorities – the majority do not have governance rights within the current structure. Given the inherent weaknesses of the funds' governance…Lothian believes that the governance of the SLGPS should be distinct from councils. A bespoke governance model should be developed which retains democratic accountability but brings greater wider involvement of stakeholders…*Lothian Group*

> Unsure how appropriate a local connection is. There is little correlation between decision making and local Council. The more important connection is that decision making around strategy is made by a well informed, well trained and experienced independent group of individuals – which should be the make-up of the decision making body, with the best interest of the pension fund members at heart. *Fife Council and Fife Pension Fund*

One respondent mentioned varying demographic profiles:

> Local arrangements ensure that the local fund's investment strategy is developed to meet the needs of its members. Demographic profiles vary considerably across Scotland and local arrangements allow for this. *SEPA*

Some respondents said a local connection was important because it connected fund strategy to the needs of employers and employees paying contributions:

> The investment strategy…is specifically designed and implemented for the benefit of employers and employees….the contribution/funding strategy…is also set locally, as contributions are paid by the council and other local employers. It would seem appropriate that there is a strong level of local accountability for the risk appetite inherent in the investment and contribution strategies combined, since these fall on the local employers *Shetland Islands Council Pension Fund*

> If the government were to decide on a full merger and a single fund for the LGPS in Scotland there would thereafter be a disconnect between the fund's performance and the local authorities who are required to pay employer's contributions into the fund. *Orkney Islands Council Pension Fund*

> The SBCPF believes it is important…that there is effective oversight and scrutiny of pension funds at local level. This is best achieved where there is close alignment between scheme members and their dependants and those charged with taking decisions. *Scottish Borders Council Pension Fund*

Some responses said a local connection was important because funds had a significant impact on council budgets:

> The LGPS represents a significant cost to local employers and decisions taken with regards to investments and retirals have a fundamental bearing on local council budgets. It is important that local decision makers understand how their decisions with regard to the workforce, e.g. the pay structure or decisions with regards to early retiral of employees, will affect both the pension fund and council budgets. *CIPFA*

> The costs of the LGPS are a significant component of the costs of employing staff and therefore are a significant element of council budgets which local councillors are responsible for. *Scottish Borders Council Pension Fund*

Respondents suggested a local connection was necessary to encourage employer and employee participation in governance:

> As a relatively small employer, local connection is essential. Having fewer more centralised funds mean that employers' forums are likely to be held further from our offices which impact on the ability to attend. *Abertay Housing Association*

> The local scrutiny of the strategy by employers and employees through the current governance arrangements allows direct questioning at all stages of the strategy process. The increased disconnection of a merged Scottish fund could not allow this level of employer and employee scrutiny therefore lessening governance of the key interested parties. *Shetland Islands Council Pension Fund*

> It is unlikely that the Comhairle would have any voice should a single fund be established. *Comhairle nan Eilean Siar*

The impact on the local economy was cited as a reason for local governance:

> The membership of the Shetland Islands Council Pension Fund in total is equivalent to about 31% of the population of the Shetland Islands. This shows how important to the local economy the pension fund is, and how important that there is a local connection to the oversight and strategy of the Pension Fund.

Respondents said that a local connection was beneficial to administrative effectiveness and fund performance

> The local connection provides scheme members with reassurance that their needs are being considered. Members have easy access to funds administration and access to information about how their funds are being managed. The local connection makes it easy for member to seek individual advice on their personal circumstances and facilitates face to face meeting when they need them. *SEPA*

> The local connection is very important to our employees who are members of SPF and to our HR, Payroll and Finance staff in the course of administering the appropriate transactions and receiving key advice and guidance. *North Ayrshire Council*

> The view of the members of the Highland Council Pensions Committee and Pensions Board is that the current arrangement works well: the interests of the members are very well served in so far as the fund is making good returns whilst providing a very responsive local service and strong governance. *Highland Group*

2. How a local model affects multi-fund employers

Multi-fund employers said that they found the division of the scheme into 11 'local' funds to be a disadvantage:

> Employers such as Scottish Water who participate in more than one fund experience different ways of interacting with fund administration, different KPIs for fund services, different

requirements for data formatting and submission, different levels of member communication support, etc., which all creates inefficiencies. *Scottish Water*

As a national employer in Scotland, we recognise the importance of local relationships and partnerships with the local authorities…however as one service, our oversight and strategy takes place at national level. In respect of the pension funds our operating model no longer aligns to that of the local authority LGPS funds our staff are in. In many cases, our staff in our Corporate Services function dealing with the funds on a day to day level are based in one of our three service hubs in the north, west and east…

…As at 31/3/2018 of our 5,263 employees contributing to LGPS, approximately half are members of the Strathclyde Pension Fund, with 17% in Lothian Pension Fund, and 8% in both North East Scotland and Tayside Funds, with those remaining spread between 3-5% across Dumfries & Galloway, Falkirk, Fife and Highland Pension Funds.

.. we currently have staff in eight of the eleven LGPS funds in Scotland and new staff…are admitted to one of eight different funds, according to where their post is geographically based. This approach was adopted to ensure that there is a fair admission of new entrants across each of the eight funds…. However there are challenges with this approach since the geographical footprint of our national organisation is no longer aligned to previous local authority fund areas. Although we are recruiting staff there is a risk of being treated as a closed employer in any of the eight LGPS funds we are in due to the geographic workforce profile.

The sustainability of such an approach is therefore diminishing as our organisation develops, resulting impractical inefficiencies in administration and communications, as well as governance and financial implications, for example;

- increasing administration burden on our HR and payroll functions dealing with eight separate LGPS funds with differing requirements
- potential confusion around which fund staff are in
- differing communications for staff even though they are in the same scheme
- different employer contribution rates, funding assumptions and funding levels impacting on our budgeting and governance requirements
- restricts our ability to engage in pension board governance as a multi fund employer
- additional complexity in compiling statutory annual report and account requirements for staff pensions and executive disclosures. *Police Scotland*

From the point of view of the [Scottish Fire and Rescue Service], communication with a single point of contact in relation to governance, strategy, administration processes and to direct members to for information would be far more useful than 8 different administrators. Currently, each administrator's contribution rate is different, meaning added complexities to our payroll system to make deductions from employees and to forecast costs – again one point of contact is preferable. The number of members in some of the smaller funds have decreased through staffing model changes, resulting in increased costs and a disproportionate share of liabilities. A single fund would remove this impact on SFRS. *Scottish Fire*

3. Varying practices

Some respondents suggested that a local connection had more disadvantages than advantages:

From our experience…regional input is more of a hindrance than a value as it results in a wide range of practice and additional cost in managing interactions…. regional funds are [usually] not aware of valuable approaches undertaken in other areas and therefore feel unable to apply them… *Robertson Group*

> While UNISON often champions the cause of localism, there are few, if any, local factors in pension management. The current performance of funds is often cited, but this is not related to geography, it reflects different investment strategies that can go up or down. Funds have not always responded quickly to new developments like fee transparency, ESG concerns and infrastructure investment. *UNISON*

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

Respondents offered views on determining if the benefits of a local connection outweigh the benefits of scale; whether scale was necessary for good governance; or whether scale existed in the SLGPS currently.

1. *Local connection in governance versus the benefits of scale*

Some responses said that scale was unconnected to maintaining local governance. For example:

> Benefits of scale are unclear and variable. The group don't agree that one can't be achieved without the other. Large funds like [Strathclyde] retain an element of local connection and smaller funds perform similarly. *SPDS*

> The aim should be to secure the benefits of scale in terms of cost reductions and increased returns whilst preserving the benefits of a local connection in the governance of funds. *Scottish Children's Reporter Administration*

> …we do not agree that benefits of scale can only be realised if local connection is lessened. It would be possible to move to an enlarged structure and retain a local connection. (e.g. the merger of 2 or 3 Funds governed by a Joint Committee or the creation of a bespoke Pensions Authority governed by elected members from underlying Councils). Even with collaboration, local connectivity can be maintained and some benefits of scale achieved – as evidenced by Falkirk's collaboration with Lothian. *Falkirk Council Pension Fund*

Some respondents suggested the benefits of a local connection could be weighed against member and employer contributions:

> If there is a compelling case made in terms of material cost reduction and increases in investment returns that materially reduces members and employers contributions to the costs of LGPS, by merging funds then local connection should be broken…There needs to be a full option appraisal to assess whether small and medium sized Funds can continue to meet their statutory and regulatory obligations…[taking] into account: key person risk and systems resilience; ability to recruit qualified staff across a range of disciplines; ability to meet member needs; cost per member; and quality of member's services. *SEPA*

Others suggested focusing on whether scale offered benefits, or whether there was sufficient certainty of scale benefits. Pooling of the LGPS in England and Wales was offered as a case. For example:

> Given that the strong local connection represents the status quo for the LGPS in Scotland it would be necessary…to advocate fundamental change, to determine that greater benefits of scale would outweigh the benefits of the local connection. Some academic evidence might suggest so, but this cannot be established with any certainty *ex ante*. *SPF*

> The Orkney Islands Council Pension Fund is the smallest of the LGPS funds in Scotland yet according to Audit Scotland "Orkney has the highest funding level relative to other pension funds in 2017/18". The Orkney Islands Council Pension Fund therefore retains the benefits of a local connection in terms of governance whilst it is difficult to see what benefits "scale"

would bring to the fund in terms of investment performance. *Orkney Islands Council Pension Fund*

Although many of the positives associated with local connection are obvious, the benefits of scale are less clear and more variable. *East Lothian Council*

As the cost of investment management and administration is not particularly large as a proportion of the fund's overall size, it is not particularly clear that there are big benefits of scale available. As the arrangement of having a local connection appears to be working (ie schemes have 100% or above funding), when weighing it up against benefits of scale it is safe to say that benefits of scale would have to be significant in order to merit taking a risk in changing the current arrangements. *Care Inspectorate–Scottish Social Services Council (CI-SSSC)*

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

Benefit of scale cannot be guaranteed/value unknown therefore cannot outweigh the known benefits of a local connection. *North East Scotland Pension Fund (NESPF)*

To date the scale benefits of the pooling exercise being undertaken in England and Wales have yet to be delivered. It should be noted that sometimes there are points in scale where costs start increasing again. Scale does not always reduce administration costs. *SEPA*

2. *Scale, good governance and good performance*

Some respondents discussed the link between scale and good governance:

The propensity to good governance in any organisation bears little, if any, relationship to scale. It is not possible to provide a coherent answer to this question. There is no evidence that larger size equates to better governance as exemplified by recent problems in some of the UK largest pension funds e.g. the Universities Superannuation Fund. One way a view could be reached on this question would be a review of pension fund accounts which already highlight the extent to which funds deliver compliance with good governance in line with the Myners principles. *CIPFA*

good governance…has no relationship to the scale of the organisation. There is no evidence that larger size funds have better governance…perform better, or that they have fundamentally lower costs simply because they are larger. In fact it could be argued that larger size may encourage complacency and a reluctance to act quickly to emerging market trends. There is no evidence to suggest that the current model is not working effectively either in terms of governance standards or in terms of investment performance. *Scottish Borders Council*

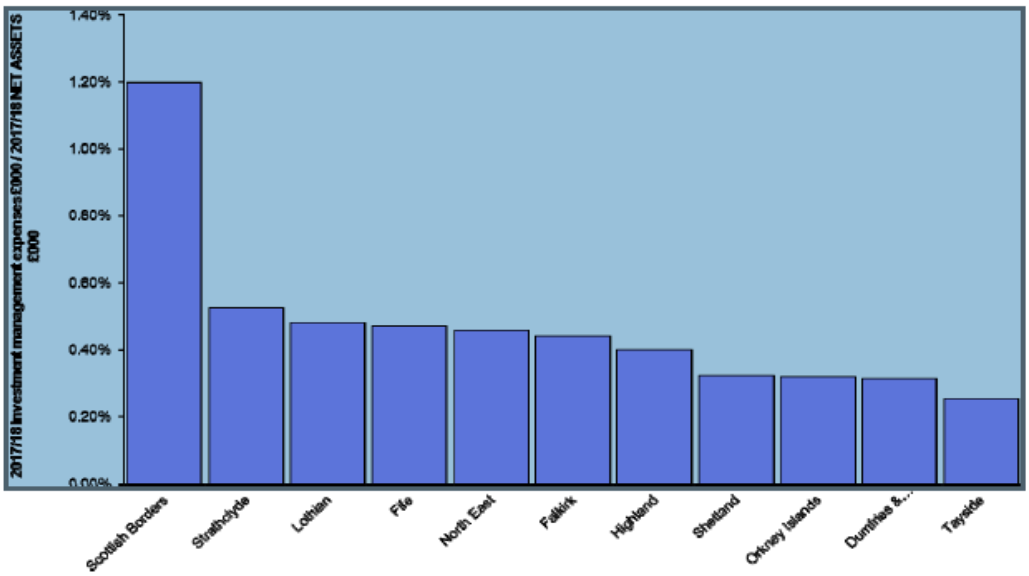
The correlation between good governance and good performance has however been demonstrated by various studies. If good governance and performance is being delivered at a local level as it the case across the SLGPS and the benefits of scale are yet to be demonstrated, change would seem unnecessary. *Highland Group*

3. *Existing scale within the SLGPS*

Some responses said there was already scale in the current structure SLGPS:

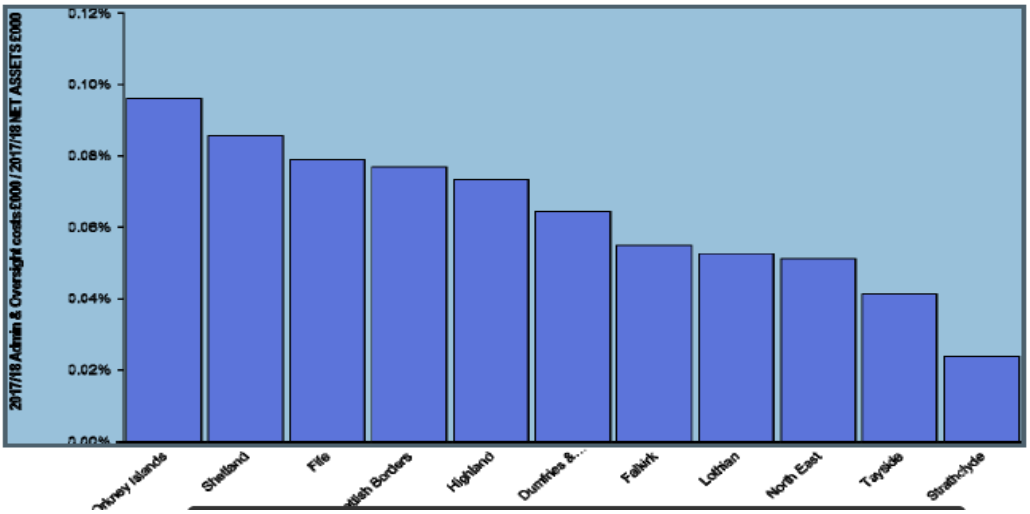
TPF already enjoys considerable benefits of scale in terms of cost at a value of almost £4bn. This is demonstrated by the independent annual reviews undertaken by Audit Scotland with the lowest investment management expenses regardless of size:

Accounts - Investment management expenses 2017-18



Furthermore having the second lowest administration and oversight costs as proportion of net assets

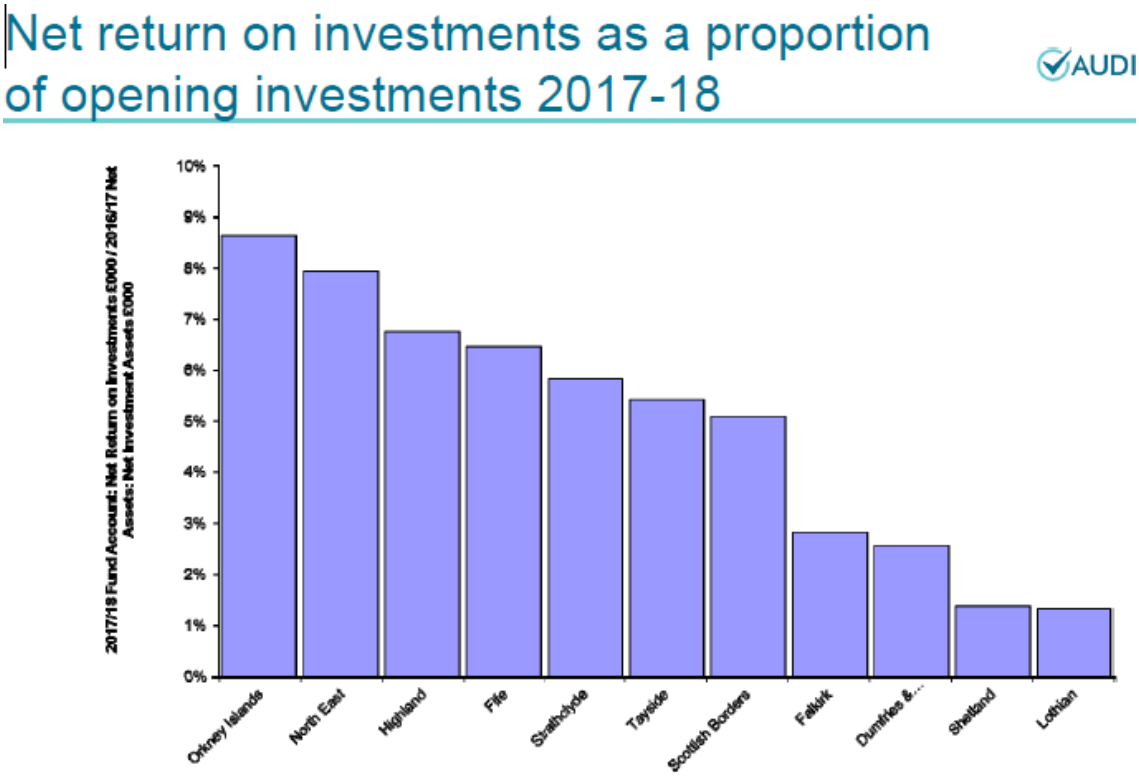
Admin and oversight costs as a proportion of net assets 2017-18



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

From the evidence above, there are lower investment costs as a proportion of assets in 8 of the 11 funds (only one of which has partial internal investment management, outsourced to another fund). Furthermore, in terms of administration and oversight, there is no huge correlation as to economies of scale that would have such an impact as to warrant fund merger.

In 2017/18, the following performance across funds was captured by Audit Scotland. From this it is clear that there are a range of returns, but these are in no way correlated to in-house, or larger schemes. *Tayside Pension Fund*



[Falkirk Pension Fund] has already recognised the advantages of benefits of scale by seeking to collaborate with Lothian Pension Fund around investment matters and have arrangements in place with Lothian to mitigate key person's risk. *SEPA*

…SPF is a large fund with assets in excess of £21 billion. Even with this scale a local connection and service is achieved to a professional standard. Therefore, there is a risk that any increase in scale could be to the detriment of this local connection. *North Ayrshire Council*

c) Operating risks

Original questions:

- How well informed do feel about the operating risks of your fund? What information do you rely on to specify and measure these?
- How well are operating risks managed in the current system?
- How would you improve the measurement and management of operating risks in the current system?

What information do respondents rely on to judge fund operating risks? How well informed do respondents feel about fund operating risks?

The majority of respondents said they relied on the fund risk registers to judge operating risks. Some cited risk management policy and strategy statements. Many used the websites of administering authorities to source this information, annual reports and AGMs. Other private sources of information included regular meetings with fund managers.

The majority respondents felt they were well informed about operating risks. They cited the following factors:

- Funds opting for professional status under MiFID 2 which requires funds to have access to appropriate professionally qualified advice to ensure they can manage risks effectively
- Robust institutional process on risk management inherited from administering authorities and applied to funds
- Training for decision-making staff in funds
- Reviews of pensions managers risk management assessments by pensions subcommittees, committees and boards
- Governance procedures and internal and external audits
- Policies to mitigate key person risks, including senior officer, investment advisor or from support and guidance in the short term from other funds

Some respondents felt less well informed because of uneven resourcing between funds or their ability to monitor funds:

> Reliant on investment advisers and Council Staff and Committee/Board members to assess overall operating risks. Not all funds have the same available internal resource to identify and mitigate and manage risk. Key person risk in smaller funds exacerbates this. *Fife Council and Fife Pension Fund*
>
> Not very well informed, unless information on risks is available through the Lothian Pension Fund website. *Children's Hearings Scotland*
>
> It is assumed that Administrators will operate their own risk registers as part of best practice…. we have 8 Administrators to communicate with and therefore would add significant workload to monitor all of them. *Scottish Fire*

How well are operating risks managed in the current system?

Responses dealt with processes to manage risks; skills and external advisors; diversification and collaboration; and cessation and legacy liabilities

1. *Controls, systems and processes*

Respondents cited a variety of controls, systems and processes as evidence that operating risks are well managed in the SLGPS.

Internal controls and a risk management culture:

> TPF has a strong focus on the identification, analysis and management of risk. Investment and funding strategies are designed to manage specific risks, and controls are inbuilt into processes to ensure that risks are managed appropriately and proportionately. *Tayside Pension Fund*

> [Strathclyde Pension Fund] has a strong risk management culture. The funding and investment strategies are firmly risk-based and all operational risks are closely managed. The Strathclyde Pension Fund Office has significant internal resource and expertise, and a robust regime of internal controls. The internal resource is supported and enhanced by a framework of external monitoring and advice including actuarial and investment consultants, auditors, and independent expert advisers (the Investment Advisory Panel). External investment managers have significant risk and compliance resources. *SPF*

> …The Council also operates a Whistleblowing policy. *Falkirk Council Pension Fund*

> Operating risks are managed in all areas of the Fund, from internal and external audit reviews to having business continuity plans…. Internally there are segregation of duties with all cash movements, and the reduction of key man risk through the involvement of various Council officers at all levels. All internal and external use of risk control is used to mitigate all possible risk and safeguard assets, which is reflected in the external auditors clean audit report. *Shetland Islands Council Pension Fund*

> Lothian has a strong risk management culture. Internal resource includes a dedicated Chief Risk Officer and a dedicated Chief Finance Officer with Section 95 responsibility for the Fund *Lothian Group*

Establishment of a separate legal entity for fund management:

> Lothian has made a number of structural changes to better manage risk in recent years (see above regarding the Fund's governance), notably the transfer of employment of officers from the council to a company which is wholly owned and financed by the Council, as administering authority of the pension fund. This is unique in the SLGPS. *Lothian Group*

Performance; internal and external audits:

> Both internal and external audit have not identified any significant issues in the pension audits they have undertaken. *Shetland Islands Council Pension Fund*

> The performance of the LGPS in Scotland and the content of external audit reports indicate these risks are being managed effectively. *Scottish Borders Council Pension Fund*

Computer systems:

> [The fund] uses a pensions administration and payroll system from a leading software house experienced in LGPS activity. *Falkirk Council Pension Fund*

> Operating risks have been significantly improved now that all 11 Scottish Pension Administering Authorities are using the [Aquila Heywood Altair Pension Administration System]. *Shetland Islands Council Pension Fund*

2. *Skills and external advisors*

Respondents differed on whether the current staffing arrangements of the SLGPS and the use of external expertise meant that operating risks were well managed.

Access to qualified staff was cited as evidence of good management. For example

> [Falkirk Pension Fund] also has a range of internal resources consisting of officers with skills and knowledge in scheme administration, payroll, funding, governance, investments, accounting and communications. *Falkirk Council Pension Fund*

> The internal investment and administration processes are managed by experienced, appropriately qualified officers. *Dumfries and Galloway Council Pension Fund*

The appointment of external fund managers and use of external advisers were cited as a positive:

> Investment risks are paramount within the setting up of an investment strategy from the use of investment consultants, through to the diversification of fund managers and the independence of the custodian. *Shetland Islands Council Pension Fund*

> All funds are managed externally, and the performance and operation of external investment managers is constantly monitored and reported to Members on a regular basis. *Dumfries and Galloway Council Pension Fund*

> External investment managers are subject to their own audit arrangements and are required to produce annual assurance and compliance statements. *SEPA*

> The fund does not manage any money internally instead relying on the expertise of professional investment firms. *Scottish Borders Council Pension Fund*

> We are also making greater use of our external advisors to reflect the greater focus on these issues *Shetland Islands Council Pension Fund*

> The Investment Strategy and Funding Strategy for the fund have been developed in conjunction with support from external investment advisers and actuaries. The strategies are constantly monitored and revised with the support of external advisers. *Dumfries and Galloway Council Pension Fund*

Some respondents suggested that small funds may not have access to sufficient skilled personnel, leading to an over reliance on external advisors and key person risks:

> In smaller funds, there is also significant risk from reliance on relatively small numbers of people within local authorities who have the requisite pension knowledge, which in turn creates heavy reliance on external suppliers. This can mean that some funds are reliant on investment advice from the same suppliers who are selling them investment management services. The conflict of interest is clear. *Scottish Water*

> The number of investment officers employed by Funds (ignoring Funds with internal investment expertise) seems low in comparison with the volume of assets at risk. *Falkirk Council Pension Fund*

> …this will differ across the range of sizes of funds. Smaller funds rely more heavily on external advisers. *Fife Council and Fife Pension Fund*

> …the existing structure potentially creates a key person risk as there is less available resource to cover key roles as well as budgetary and staff risk due to other competing local priorities. *Robertson Group*

3. *Collaboration and diversification*

Respondents mentioned collaboration as evidence of operating risks being well managed in the scheme. They disagreed on how the diversity of operating approaches in the SLGPS affected the management of operating risks.

Collaboration and resource sharing with other funds was cited as evidence of good practice:

> …the Fund partners with Lothian Pension Fund in order to share in and have access to a broader investment resource. The Fund's external investment managers are subject to their own audit arrangements and are required to produce annual assurance and compliance statements. *Falkirk Council Pension Fund*

The structure of the SLGPS was cited as either offering diversification of operating risks, or creating concerns about operating risks:

> Having 11 funds in operation with differing investment strategies provides suitable diversification and risk management for the Scottish LGPS. *Tayside Pension Fund*

> We recognise that although [there is] one LGPS in Scotland, each fund has differing approaches to investment, governance, administration etc, and resulting operating risk controls/appetite. This again highlights a lack of commonality and ability to seek appropriate assurance on the overall effectiveness of the LGPS in Scotland. *Police Scotland*

4. *Cessation and legacy liabilities*

Robertson Trust and SCVO highlighted the treatment of legacy liabilities as an operational concern for the SLGPS. This included unfair assignment of liabilities and membership of the scheme discouraging charities from undertaking public sector contracts:

> Charities and not for profit organisations are an integral part of Scottish LGPS…these admitted bodies account for about 83% of total employers and around 17% of the 218,669 active members.
>
> Consistent feedback from third sector participants in LGPS highlights poor clarity in communication, a lack of focus on these organisations' specific circumstances, limited flexibility when considering exits from the Fund and an inequity in dealing with legacy liabilities, relating to public sector employers, accrued in the Funds. These findings are wholly consistent with those recently identified as part of the Tier 3 review commissioned by the Scheme Advisory Board in England and Wales.
>
> Our organisations are wholly supportive of any steps taken within LGPS which would provide increased engagement, lower benefit costs, a greater level of consistency and above all greater fairness in how third sector organisations are treated. We are also wholly supportive of the proposals made by [the Institute of Chartered Accountants Scotland] in September 2017. In addition we recognise the steps taken by Scottish Government in updating LGPS Legislation in 2018 to increase flexibility however remain concerned by the limited level of traction the Regulations have achieved given a lack of commitment from the individual Funds. Our key concerns are that any review should also address the following:

The attitude of Funds to legacy liabilities which have been passed on to charities by Councils and other public sector bodies. It is very common when analysing charity liabilities that very significant proportions of these liabilities relate to staff who had service built up prior to working with the charity. These transfers of liability were not clearly communicated to the charities and while they may have been transferred at the time on a 'fully funded' basis, this calculation was on an 'on-going' basis and not on the 'cessation' (nil risk gilts basis) that charities are asked to pay on exit. This means that Councils are just expecting charities to absorb these liabilities and effectively pay for them on behalf of the public bodies. This seems wholly inequitable. We have seen numerous examples of organisations being left with these liabilities as Councils and/or Scottish Government refuse to accept responsibility for them even though it is clear that they were built up by them and indeed had agreements been written now they would have had to guarantee them. This is also an area where there has been a huge divergence of approach between Funds. Lothian Pension Fund has amended its Funding Strategy Statement to look to address the issue of legacy liabilities formally. While a small number of others will consider it informally, the vast majority, due to not having any practice in place, are rejecting any proposals. This was an issue raised in the ICAS paper but was not dealt with in the new Regulations. This we feel has to be addressed and in our view further consolidation between the LGPS funds is likely to make consistent practice more likely.

There is a huge lack of consistency and clarity in relation to pensions associated with public sector out-sourcing contracts. The charitable sector is very well placed to perform these duties in many cases, but are discouraged from doing so by the complexities associated with LGPS participation. This is not in the interests of the charities, public bodies or indeed the tax payer should these services not be being provided by those most suitable and most able to offer cost effective provision because of the complexity, inconsistency and risk of the associated pension provision. A single, consistent, risk managed approach would therefore be hugely valuable. *Robertson Group*

How would respondents improve the measurement and management of operating risks in the SLPGS?

Responses covered risk reporting, benefits simplification, common software platforms, and training and treatment of cessations as means of improving measurement and management of the scheme's operating risks, cessation

1. *Standardised reporting*

Respondents proposed greater standardisation and disclosure of the risk register and fund performance reporting, including a framework of standards expected of the SLGPS to measure performance against. It was also proposed that SAB should collate and publish risk registers annually.

2. *Benefits simplification*

Many respondents proposed that benefits should be simplified:

The regulations associated with scheme benefits have over the years become more and more complex. At present there are in effect 3 benefit schemes in operation (1/80th, 1/60th, 1/49th) as well as numerous administering body and employer discretions available through the differing regulations. This complexity significantly increases operating risks associated with administering benefits. *Tayside Pension Fund*

The complexity of the scheme regulations and associated legislation severely exacerbates operating risks. The regulations should be simplified. *SPF*

> Certain aspects of scheme administration are extraordinarily complicated (e.g. 30 contribution rates now compared to 2 rates a decade ago; Certificates of Protection, Aggregation rules to name but a few. *Falkirk Council Pension Fund*

3. People, processes and systems

Sharing of best practice was suggested as was greater training and management of key person risks, variously for governance personnel, administrators, decision makers and members of SAB:

> By looking at what other funds are doing in terms of risk mitigation and learning and assessing best practice in this area. *Fife Council and Fife Pension Fund*

> Those charged with governance should be required to undertake mandatory training in the form of the Trustee toolkit provided by the Pensions Regulator, evidencing training modules that have been passed to ensure they have a good understanding of operating risks. All decision makers should be required to undertake annual training and evidence their participation in training events. *Scottish Borders Council*

> Funds to have succession plans formulated. A training policy for members of the Scheme Advisory Board to ensure that they have requisite skills and knowledge in line with Myners principles. Have attendance at meetings and training undertaken reported in SAB Annual report. *Falkirk Council Pension Fund*

> Due to the complexity of the LGPS and other associated regulations, it's imperative to undertake continual staff development/training to ensure all pension administering staff are fully trained and multi-skilled so as to ensure key man risk is mitigated. *Shetland Islands Council Pension Fund*

> Ensure all members responsible for decision making have received appropriate and regular training so they are fully aware of operating risks. *Dumfries and Galloway Council Pension Fund*

> As recommended by [the KPMG review], improved governance relating to the Scheme Advisory Board and Pension Boards, including clarity of roles and responsibilities and training requirements for its members, would help with the scrutiny of the SLGPS and focus on the appropriate issues and risks. *Lothian Group*

Respondents suggested that administering authorities should consolidate their use of the Aquila Heywood Altair LGPS software onto the cloud:

> If the LGPS in Scotland had a common software platform that was cloud based it would be possible to obtain common reports that captured the statistical information from all funds giving much better management information. There may be a risk to this of concentrating all the administration data on one platform but as a cloud based platform the usual redundancies should be built in. *Orkney Islands Council Pension Fund*

4. Cessation regulations

Better transparency and communication for the treatment of cessations was recommended:

> The cessation position and process is not clearly understood by many third sector participants and we believe that greater transparency and better communication is required from the Funds. We would propose that admitted bodies are provided with an estimated cessation valuation annually with a clear description of what this means. Some Funds already provide this on request as part of FRS102 disclosures but it should be incorporated as practice. *Robertson Group*

d) Infrastructure

Original questions

- How well informed do you feel about your fund's investments in infrastructure? What information do you rely on?
- How do you rate the current system's ability to invest in infrastructure?
- How would you increase investment in infrastructure in the current system?

What information do respondents rely to understand funds' investments in infrastructure? How well informed do respondents feel?

Respondents cited the following public information sources they used to understand infrastructure investments by funds: investment sections of annual reports; quarterly performance reports; AGMs; and committee papers published on administering authority websites.

Pension board respondents said they received reports and information updates from administering authorities. Some pension fund respondents cited meetings with fund managers, performance information from fund managers and the results of reviews by panels of investment professionals.

Many respondents described their infrastructure investments; rationale for not investing or joint investments with other pension funds. For example:

> The creation of a Joint Investment Strategy Panel with the Lothian Fund and Independent advisers allows more time to be spent analysing infrastructure investments. *Scottish Children's Reporter Administration*
>
> Scottish Borders Council Pension Fund is actively collaborating in a range of Infrastructure investments with Lothian Pension fund. This arrangement provides cost effective access to investment opportunities which are also being accessed by Falkirk, Fife and NILGOS. *Scottish Borders Council*
>
> FPF has been investing in infrastructure as a distinct asset class for approximately 7 years. Initially this was through a global Fund of Fund manager and since 2014, this has been in conjunction with Lothian Pension Fund, leveraging on their in house investment team to execute deals with specialist managers mainly in the UK and (to a lesser extent) in European markets. *Falkirk Council Pension Fund*
>
> SPF has made 18 separate investments totalling over £500m in UK infrastructure, including £150m in Scotland, through its Direct Investment Portfolio… *SPF*
>
> The Shetland Islands Council Pension Fund does not currently have any investments in infrastructure. All investments are compared and analysed by our investment consultant before deciding which assets best fits into the Fund's investment strategy. *Shetland Islands Council Pension Fund*

How do respondents rate the scheme's ability to invest in infrastructure?

When judging the scheme's ability to invest in infrastructure respondents said:

1. Large funds have sufficient scale
2. Difficulties and inefficiencies for smaller funds
3. Cooperation

Respondents also gave views on the role of fund strategy and fiduciary duties in the investment process; these have been aggregated with similar comments in the next question.

1. Large funds have sufficient scale

Some respondents suggested that large funds in the scheme had sufficient scale to invest in infrastructure and gave examples of existing investments.

> As with other asset classes, infrastructure investment requires a sound understanding of risk, return and governance characteristics. Like other private markets investments, infrastructure is relatively illiquid, supply-constrained and expensive. But there are no insurmountable barriers, as SPF's £1 billion of investment to date demonstrates. *SPF*

> Larger funds have the scale to gain access to infrastructure assets using an in house team that the more direct approach involves: having the capacity to source, analyse and execute deals internally; having the capacity to address the legal and tax complexities that will arise, and having sufficient market presence and credibility to be offered investment; and opportunities at an attractive price. *SEPA*

2. Difficulties and inefficiencies for smaller funds

Several respondents suggested that smaller funds lacked the resources to directly invest in infrastructure and although they could use funds-of-funds, they would pay higher fees to do so:

> Whilst there are funds which have particular experience in this area, most do not, so thus it is important to ensure that whatever solutions / vehicles are used to facilitate investment, they are appropriate for the specific investor and the fund's requirements. *Tayside Pension Fund*

> Under the current system, smaller funds and some of the medium sized funds will be investing in Infrastructure assets through a Fund of Funds structure which (as Falkirk Pension Fund has done) allows LGPS Funds to invest in a diversified portfolio of global assets without the administrative overhead that comes from taking a more direct investment route. The Fund of Funds approach means that there is significant return leakage from fees. *SEPA*

> In addition, there is potentially a lack of alignment between a Fund's long term strategy to meet its liabilities and the "buy and flip" style of some infrastructure managers. *Falkirk Council Pension Fund*

> Given the size of infrastructure projects, smaller funds may have difficulty in finding suitable investment opportunities. If no specific projects are available then investment is restricted to buying into pooled vehicles currently run by external investment managers. *Dumfries and Galloway Council Pension Fund*

> The principal impediment to investment in infrastructure for small funds is the lack of suitably attractive investment opportunities that are packaged in a manner that make them easy to access. For larger funds that have larger sums to invest there are significant infrastructure investments already completed. The due diligence requirements, scale of investment required

> and high level of entry costs is definitely a deterrent to direct investment in infrastructure for small funds. *Orkney Islands Council Pension Fund*

> Infrastructure investing does have different governance characteristics, is more expensive to invest into, relatively illiquid and there are supply constraints… investing directly into infrastructure requires specialist knowledge but there are different options …that could be utilised if the asset class was perceived to be a good investment for the fund's strategy, through to pooled vehicles already available and established in the pension investment universe. *Shetland Islands Council Pension Fund*

3. Cooperation

Some respondents said they had been able to invest in infrastructure by partnering with the Lothian Pension Fund or had some discussions with the fund:

> Scottish Borders has made an allocation of 5% of assets under management to infrastructure and is investing in this asset class in collaboration with Lothian Pension Fund. *Scottish Borders Council Pension Fund*

> In August 2018, officers invited Lothian Pension Fund to present to the Investment Sub Committee on their collaboration with other LGPS funds to invest in infrastructure. The Fund would consider collaboration as a potential route alongside others if an investment was to be made in infrastructure. *Highland Group*

> Lothian's infrastructure exposure has been made possible due to the Fund's in-house investment expertise and the governance arrangements which facilitate nimble decision making. Most other SLGPS funds who invest in infrastructure rely on fund-of-funds managers where the deployment of capital can be slow, costs are significantly higher and tailoring the investment strategy difficult. Lothian's FCA authorisation has facilitated Falkirk Council Pension Fund and Borders Pension Fund to access Lothian's due diligence on infrastructure (and other) investments…*Lothian Group*

> [Falkirk Pension Fund] has only been able to invest directly through its collaborative arrangement with the Lothian Fund. This has enabled FPF to make around 20 investments directly with specialist managers totalling around £100m. The investments include a number of Scottish/UK assets including utilities distribution networks, solar, hydro and wind farms, transportation concessions and water companies. *Falkirk Council Pension Fund*

How would respondents increase infrastructure investments in the current system?

Responses on increasing infrastructure investment in the current system covered:

1. Fiduciary duties in fund asset allocation
2. Appropriate protections for funds
3. Increasing supply
4. Using collaboration to boost investment
5. Fund maturity and financing

1. Fiduciary duty and fund asset allocation

Many responses said the choice of individual funds to invest in infrastructure depended on the asset being appropriate to the funds' investment strategy and this process should not be usurped by public policy. For example:

> Investment in infrastructure is established as a part of the investment portfolio. The main issue is that the fund only considers investment in infrastructure when it is the best decision to maximise the return on investment for the fund. It is essential that the decision is not taken in order to provide low cost capital for investment in public infrastructure. *Argyll and Bute Council*
>
> The principal objective of a pension fund is to build up a fund of assets sufficient to meet future pension fund liabilities not to fund public infrastructure projects. There is an inherent tension between optimizing risk and return for pension funds and delivering public investment in infrastructure at the lowest possible cost to the taxpayer. *Scottish Borders Council Pension Fund*
>
> We strongly believe that potential use of pension funds to invest in infrastructure should not be a driver for any structural change. Potential investment options should only be considered if the related returns justify investment level – this should always be a decision for pension fund investment managers and should not be driven by political policy objectives. *East Lothian Council*
>
> Those administering the LGPS funds have a fiduciary duty to their members and employers and therefore the Scottish Ministers should not compel the SLGPS funds to make any such investment. LGPS assets should not be used to satisfy a political appetite for economic regeneration. The governance relating to infrastructure investments should avoid conflicts of interest, particularly in relation to 'local' investments. *Lothian Group*
>
> Funds should only invest in infrastructure as part of its alternative portfolio if the return, risk and liquidity meet the investment strategy as the aim of the fund is to provide retirement and death benefits to its scheme members. The legal requirement on funds to achieve this objective should not be breached for political gain risking pensioners' and local employers' financial security. *Highland Group*

2. *Appropriate protections*

One response suggested appropriate protections would be needed if pension funds were linked to public policy on infrastructure:

> The political desire to use pension funds for investment in infrastructure projects must be carefully considered. We would not wish to see our member's pension funds used in such a way as to provide a back-stop loan scheme for the Scottish Government. Decisions to use funds in this way must come with an absolute guarantee that pensions will be protected and underwritten by the Scottish Government.
>
> We only have to look at the fiasco of recent building and infrastructure projects in Scotland which have fallen behind schedule, delivered buildings that are unfit for purpose and in some cases proved to be dangerous. Therefore the distance between SLGPS investment funding a project, and the infrastructure project itself, must be sufficient as to guarantee that the fund itself will not face litigation.
>
> Furthermore, the collapse of Carillion highlighted the lack of accountability and scrutiny of one of the UK's largest infrastructure providers and what followed was excessive executive pay and dividends to shareholders were prioritised above jobs, workers and their pensions.
>
> We therefore need to ensure complete transparency and accountability in investments to avoid putting control of funds into the hands of unaccountable company directors or non-elected quangos. Presently the Scottish Futures Trust has significant control over public

procurement contracts. However Unite believes there is a lack of transparency and accountability around the projects they are involved with. *Unite the Union Scotland (Unite)*

3. *Increasing supply*

Many responses suggested improving the supply of investments that were a 'suitable proposition' for funds. For example:

> Investment in infrastructure would increase if the supply of attractive opportunities increased, or the risk/return characteristics were improved. For example, the feed-in-tariff regime has been instrumental in increasing institutional investment in renewable energy. SPF has taken full advantage of this opportunity with investments of over £330m. *SPF*
>
> With increasingly mature liabilities and a trend of reducing investment risk, many funds are increasingly looking for lower-risk investments. Infrastructure investments with long- term, secure inflation-linked income could therefore prove to be attractive. Funds are generally not looking to invest in speculative developments. Guarantees provided by institutions with secure financial backing could enhance the attractiveness of investments. *Lothian Group*
>
> One practical solution could be to allow pension fund to tender for the provision of senior debt finance to schools projects when these are being developed. *CIPFA*
>
> Infrastructure investments are likely to be attractive to LGPS where the underlying asset has an income stream that is linked to inflation and or underpinned by regulatory requirements such as water or electricity. Investments need to show the right sort of risk, return and governance characteristics to be potential investments. Infrastructure investments are a complex vehicle, are illiquid and carry risks (as evidenced by the demise of Carillion and the collapse of the Morandi Bridge in Genoa). *SEPA*

This included looking at Scottish Futures Trust proposals on pooled housing infrastructure investments, or in general establishing investment vehicles that provided the risk-return characteristics required by funds:

> The Scottish Futures Trust has recently undertaken work in this area and published a paper with regard to housing infrastructure investment. The structures to easy enable such large scale investment in infrastructure, which balances suitable returns within an optimized risk profile, with low cost project funding which can match [Public Work Loan Board] costs, are not however yet suitably developed. Development of such a model would help to facilitate infrastructure investment. *Scottish Borders Council Pension Fund*
>
> If there were a suitable investment vehicle that offered the pension fund a route into infrastructure investment with an appropriate return for the level of risk, that might be persuasive. *Orkney Islands Council Pension Fund*
>
> Many local authorities and other public bodies are currently investing in major infrastructure projects through [Public Private Partnership/Private Finance Initiative / BDMF] schemes. Funds could be given the opportunity to provide some of the funding for schemes of this nature, either directly or through a pooled vehicle. *Dumfries and Galloway Council Pension Fund*
>
> If, going forward, the SLGPS fund managers are seeking to utilise its assets in infrastructure including procurement projects, Unite would support the feasibility of setting up of an independent, publicly owned company which would oversee public procurement and infrastructure contracts; making it fully accountability and wholly transparent. There could also be opportunities to make links with the Scottish Investment Bank. *Unite*

4. *Using cooperation to boost investment*

Cooperation between funds, and between public bodies which might supply infrastructure investment, was suggested:

> This is possibly where greater collaboration between the LGPS could assist with looking at prospective infrastructure products and assisting with the due diligence requirements. *Shetland Islands Council Pension Fund*

> Collaboration between funds and other public bodies could be encouraged. *Dumfries and Galloway Council Pension Fund*

5. Fund maturity and financing

Fund maturities and financing were cited as limiting factors for funds' ability to invest in infrastructure:

> It should also be recognised that Infrastructure by its very nature is long term and such an asset class may be more suited to mature funds that are seeking to match pension payments to secure steady cash flows. The Orkney Islands Council Pension Fund is gradually maturing but has not yet reached the point where it has to change its investment strategy to a matching approach. *Orkney Islands Council Pension Fund*

> The Council would view the expectation of the financial returns from the pension funds as being expensive in comparison to the borrowing that it can currently access so the wider opportunities around investment in private sector infrastructure development is of greater interest than in investing in Council capital investment plans. *Aberdeen City Council*

> The limiting factor on the Comhairle's investment in infrastructure is the availability of finance to fund investment rather than the accessibility of capital. *Comhairle nan Eilean Siar*

e) Respondents additional comments about Option 1 and respondents explanations for their preference for Option 1

This section summarises respondents additional comments on Option 1 and also includes relevant comments from Question 5a 'Which option does your organisation prefer?'

Arguments in support of Option 1: Status Quo

Respondents gave the following reasons for supporting Option 1, maintaining the status quo:

1. SLGPS is a success story
2. SLGPS funds already enjoy scale benefits
3. Local governance is integral to the success of the SLGPS
4. Lack of empirical data to support other options
5. Public infrastructure policy should not drive change
6. Changing structure not the solution
7. Risks and diseconomies of scale

1. SLGPS is a success story

Many respondents said 'if it isn't broken, don't fix it'; the SLGPS is success story and so the status quo should be preferred. Responses cited the scheme's funding level; scale; industry awards; costs; performance; quality of external fund managers; employee participation rates; and governance: For example:

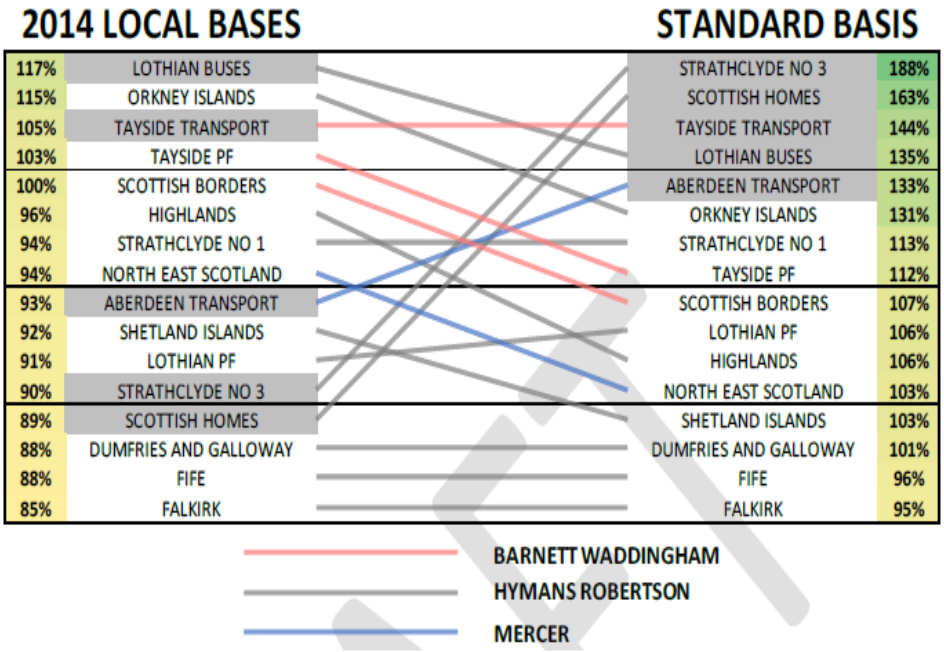
The saying of “if it isn’t broken then don’t fix it” appears relevant as the current Scottish LGPS. Funds are in a good funding position. *Shetland Islands Council Pension Fund*

[members] felt that the consultation document was imbalanced as the focus was on perceived weaknesses of the current structure and how the Pension Fund balances could be invested in the future and there was no reference to what worked well in the current arrangement. *Highland Group*

The LGPS is one of the major success stories associated with Local Government in Scotland. The current arrangements are well established, having been in place with Administering Authorities since 1995. There is therefore a significant track record of delivery which is supported by often long established relationships with a range of respected fund managers.

All funds have delivered positive net investment returns over time and the recent valuation demonstrates that funding levels in all 11 funds were very high, with most funds exceeding, and all funds almost meeting, their primary objective i.e. to have a fund of assets that is sufficient to meet pension fund liabilities as they fall due. *CIPFA*

This can best be evidenced in the funding position. The Scottish funds are all close to or above 100% funded meaning that their primary objective has been achieved. The LGPS in Scotland has for very many years been better funded than its equivalent in England and the rest of the UK. The [Government Actuary’s Department] Section 13 report which analysed all Scottish funds on a standard basis demonstrates this strong position, but also that funds do not necessarily have to be big to be successful. The David and Goliath of Orkney versus Strathclyde shown below is testament to this. *Tayside Pension Fund*



The performance of the SBCPF has allowed the Council to retain a contribution rate of 18% since 2004 providing stability and cost certainty. *Scottish Borders Council*

Employee participation rates in the LGPS are high and stable. No fund has seen significant withdrawals of assets by members following the implementation of recent pension freedoms. The advent of auto enrolment has seen an increase in membership. This broadly stable membership position indicates members value their pension benefits and trust that they are being well managed. The de-stabilising effect on the membership of any large scale reform needs to be carefully considered before any changes are made…The costs of administering the scheme in Scotland are relatively low and stable, with some variation in the level of

administration cost between funds which may be a result of different level of fee disclosure and of relative size. *CIPFA*

The Shetland Islands Council Pension Fund at the last actuarial valuation in March 2017 had a calculated funding level of 90% on a prudent basis, which maintains a good ability to cover current and future pensions. This level of funding along with strong governance shows that the fund is well placed for the future. *Shetland Islands Council Pension Fund*

2. *SLGPS funds already enjoy scale benefits*

Several responses said that some of the funds in the SLGPS already enjoyed scale benefits. For example:[13]

SPF has a current value of £21.5 billion, current membership of 233,000 and a current funding level in excess of 112%. SPF has a governance structure and risk processes appropriate for a fund of this very significant size, utilising internal and external expertise. SPF enjoys considerable benefits of scale in terms of cost, influence, and access to investments and is able to manage or avoid the potential downside that scale can bring (lack of flexibility, insufficient scale of opportunity, concentration of risk). SPF has existing infrastructure commitments of over £1 billion. The infrastructure strategy is relatively new and this total is likely to increase, particularly if attractive opportunities continue to emerge. From an SPF perspective, it is not clear what would be gained by its members or participating employers from adoption of any of the proposed alternative models. It is certain, though, that there would be significant costs and risks associated with any change. *Glasgow City Council*

3. *Local governance is integral to the success of the SLGPS*

Some respondents said that maintaining the performance of the SLGPS required retaining the local ownership of the status quo option.[14]

COSLA believes that local accountability and oversight carried out by local elected members in decisions relating to the pension funds should remain a matter for local determination and that this 'local' ownership is crucial to effective cost control and sustaining good governance. The local nature of decision making guarantees an effective voice for employee representatives on pension fund boards, as well as that of employers. This local voice may be lost under aggregated, less local models of governance. *COSLA*

4. *Lack of empirical data to support other options*

Many respondents said that strong data would need to be presented to justify a change to the structure of SLGPS. For example:

The Directors of Finance recognises that the 11 fund current structure is not one that would be implemented were a new system being designed afresh from scratch. The Section is however also of the view that the current system is working well, has significant strengths and the importance of the scheme to its thousands of members is such that reform should only be undertaken with extreme care. Any changes must be based on sound empirical data not based on hoped for advantages, ideology, or any preconceived notions that changes will deliver improvement in the current position.

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[13] Other comments from respondents suggesting funds in the SLGPS have scale can be found earlier in this section: "How would respondents determine if the benefits of a local connection in governance outweigh the benefits of scale"

[14] A fuller analysis of respondents' comments about local connection is given earlier in this section at "How important do respondents feel for funds to maintain a local connection with respect to oversight and strategy?"

In this regard it is worth noting that much store has been placed by other commentators on limited published data concerning investment published by APG and covering a single time period (2001-2009). This is a short period in the history of the LGPS when investment returns delivered were relatively low. This should be viewed with caution. It would be more appropriate if the performance of the LGPS in Scotland is to be scrutinised that this be undertaken using multiple rolling time periods when a very different picture of performance will emerge.

A view has also been promulgated using analysis prepared by APG on behalf of UNISON that based on this one time period (2001 -2009) the four largest UK LGPS funds performed better than average. It should be noted however that there are over 100 funds in the LGPS and the limited analysis undertaken by APG over this single period should be treated with extreme caution. It is equally valid to say for example that some of the smallest funds in the UK have performed equally well, if not better, over the long period, and there is no evidence to suggest that the merger of funds to create larger bodies or pools will deliver better investment returns simply by virtue of their enhanced scale.

It is also possible, if selective time periods are used, to draw entirely different conclusions. For example an analysis of the study performed by [Mercer] for the Scheme Advisory Board using more recent Scottish 5 year data covering the period 2010 - 2015 indicates that there is no positive correlation between fund size and investment return. *CIPFA*

The Fund believes that there is no reliable empirical case for change and much more work would have to be done to evaluate the benefits and significant risks associated with change before this could be supported as being in the best interests of the fund membership. … This option represents the Status Quo for the LGPS in Scotland and any other options considered must deliver demonstrably better outcomes, based on robust empirical data, for them to be seriously considered. *Scottish Borders Council Pension Fund*

Any changes recommended to ministers as a result of this consultation exercise must deliver better outcomes, based on robust empirical data. The current evidence base for change is at best weak. Making changes to the current arrangements without robust supporting evidence, would be a major failure of governance. *Scottish Borders Council Pension Board*

COSLA would be concerned that the cost of re-structuring would outweigh as yet any un-evidenced savings, particularly where any benefit may not be derived for many years to come. There is no evidence that cost savings will demonstrate fee reductions, as evidenced in the actions underway in England and Wales, which do not appear achievable without costly re-structuring. *COSLA*

Any option to remove local control of the pension fund would require very strong evidence to show that it would be beneficial to the fund and its membership and employers. The options proposed to pool and merge funds have many issues which have unknown outcomes, and they do not have the level of evidence or assurance to make them viable alternatives *Shetland Islands Council Pension Fund*

Orkney Islands Council Pension Fund recognises that due to the small scale of its Fund that it has some vulnerabilities that may be removed in a larger organisation but it is highly sceptical that there would be any significant improvement in cost management or performance. From a position of relative strength our Fund is concerned that any change would be to our detriment. *Orkney Islands Council Pension Fund*

Some respondents suggested that the experience of the local government pension scheme in England and Wales was not useful to justify a change to the status quo:

the consideration of pooling and greater focus on infrastructure in England and Wales has been borne partly out of a much poorer funding position south of the border than we experience in Scotland: importing solutions from other parts of the UK which are in very different situations is not necessarily appropriate for the Scottish Funds. *Shetland Islands Council Pension Fund*

> The evidence to support change is at best selective. Pension fund reforms being undertaken in England and Wales have proved expensive and have yet to demonstrate any positive impact on fund performance. *Live Borders*

> It may be that some marginal cost savings could be delivered by fewer, larger funds over the longer term. Evidence to support this view is however again at best limited and it should be noted that some of the largest UK pension funds have recently experienced funding and governance issues. *Scottish Borders Council Pension Fund*

5. *Public infrastructure policy should not drive change*

Many responses said that public policy on infrastructure investment should not be used as a justification for changing the structure of the scheme and public policy should focusing on boosting supply. For example:[15]

> …the principal objective of a pension fund is to build up a fund of assets sufficient to meet future pension fund liabilities not to fund public infrastructure projects. There is an inherent tension between optimising risk and return for pension funds and delivering public investment in infrastructure at the lowest possible cost to the taxpayer. Infrastructure does have a role to play in delivering investment returns as part of a diversified portfolio of assets where the risks and returns are fully understood. The delivery of Investment in infrastructure per se should not however be seen as a primary objective of the LGPS. *CIPFA*

> To restructure the Scottish LGPS simply to secure additional investment in Scottish infrastructure could be a hugely costly mistake. If the Government's aim is to increase infrastructure investment, then it would be best achieved from the supply side (i.e. making suitable projects available for Funds to invest in) rather than mandating a demand for a limited number of opportunities. *Shetland Islands Council Pension Fund*

> Restructuring the Scottish LGPS simply to secure additional investment in Scottish infrastructure could be a hugely costly mistake. Those charged with stewardship of the LGPS [are required]…to earn the maximum return possible for the level of risk taken. Just as investments in arms, fracking, fossil fuels etc may be controversial, if they are on balance the best investments to meet the objectives of pensions funds then that is where pension funds are invested. Government should therefore concentrate on developing a package of infrastructure projects that can be placed in a suitable "wrapper" to make investment in Scottish infrastructure an attractive option for the Scottish LGPS funds. *Orkney Islands Council Pension Fund*

6. *Changing structure not the solution*

Some responses said that changing the structure of the scheme would not resolve the challenges it faces currently; earlier reforms needed time to bed in; or that incremental changes were preferable:

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

> As a whole, the Scheme faces significant challenges in the form of: complicated legislation; employer affordability; the demand for improved governance standards from The Pensions Regulator; cyber security; and environment and sustainability risk management, as we transition to a low carbon world to meet climate change challenges. All of these challenges will persist irrespective of the structure in place. *SEPA*

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[15] Respondents' made similar arguments about public policy and infrastructure investment in the scheme in this section at 'How would respondents increase infrastructure investment in the scheme?'

> The LGPS faces significant challenges, but then so do the rest of the public services, and the reforms being consulted upon within this consultation are unlikely to solve these issues or lead to better outcomes. They could in fact prove highly costly and do significant damage. *Scottish Borders Council Pension Fund*

> A restructure of the Scottish LGPS would be appropriate if the 11 Scottish Funds were in a very different situation with much lower funding levels, but given the current situation it is difficult to see what the overall benefit a change would make. There are many challenges for the Pension industry but these are being dealt with through proper governance and careful investment management, delivered by local decision-makers, as the results show. *Shetland Islands Council Pension Fund*

Some responses said earlier reforms needed time to bed in before any change should be considered. For example:[16]

> …the LGPS transparency code, the advent of pension boards, with strong employee representation, improving levels of collaboration between Councils and the sharing of benchmarking data all need to be given time to bed in and be properly evaluated before any more radical changes are considered…*CIPFA*

Some responses suggested incremental changes should be preferred over structural change:

> …we acknowledge there is scope for improvement, with the main key areas being highlighted within the SAB consultation report e.g. duplication in external costs, requirement for greater transparency and reporting etc and these have the potential to result in quicker wins. Based on the information provided, there remains a strong and clear argument, which we will aim to set out, in favour of incremental rather than radical change to the SLPGS. *NESPF*

Some respondents suggested change to the SLGPS could be addressed piecemeal among funds rather than to the entire scheme:

> If there are drivers for structural changes within the LGPS these could be addressed more locally. *Glasgow Kelvin College*

7. Risks and diseconomies of scale

Many respondents said that change carried risks including diseconomies of scale which should mean the status quo is preferred. For example:

> It should also be noted that smaller scale funds, unburdened by weighty governance structures can often move quickly to access attractive niche investment opportunities. For example the Borders recently accessed a long lease property mandate which now has a six month investment queue. While economies of scale may be possible the costs associated with transitioning to new investment mandates will offset such savings for years to come. In the absence of evidence to the contrary the SBCPF is of the view that such change is likely to have a detrimental impact on performance and pensioner confidence and for this reason believes the status quo should remain while proper evaluation of the evidence supporting any change is undertaken. *Scottish Borders Council Pension Fund*

Arguments against Option 1: Status quo

Respondents gave the following arguments against Option 1, maintaining the status quo:

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[16] Additional comments about allowing earlier changes to bed in can be found under each of the 'How would respondents improve…' questions on reporting of costs, governance and management of operating risks.

1. The status quo is not optimal and faces rising contribution rates and falling employer participation
2. Benefits of scale, including consistency and transparency
3. Protection of deferred benefits
4. Unsustainable for multi-fund employers

1. Current positive indicators does not mean the status quo is optimal

Some responses said that even if the status quo was positive it was possible to improve or that these were the best conditions to address the scheme's challenges rather than wait for a crisis:

> We agree with the Strathclyde Pension Fund that the Scottish LGPS has been a success story. The Scheme has delivered excellent benefits for a large swathe of the population over a long number of years. Membership levels have remained robust and are a sign of confidence and trust in the Funds. Funding levels have improved and compare favourably with the English and Welsh Funds. There has also been a good track record of Scottish Funds working together to share ideas and develop best practice.
>
> That does not mean that the structure of the scheme is optimal, nor that the structure should be moribund and unchanging. Set against the positives outlined above, employer contributions rates are high at a time of extreme pressure on public finances and Funds are constantly grappling with the complexities of the ever changing pensions environment.
>
> With up to 10% of the Scottish population having a stake in the Scheme, it is essential that the structure enables the Scheme to deliver effective outcomes for all of stakeholders in an increasingly complicated and regulated pensions world.
>
> In our view, it is essential that the options for the way forward are evaluated against clear objectives – the need to provide a stable, secure, high quality service for scheme members and an efficient, well governed and affordable Fund for employers and Council taxpayers. In other words, the structure should be the one that delivers best outcomes for the stakeholders. *Falkirk Council Pension Fund*
>
> The SLGPS is in a reasonable financial position although we recognise the weaknesses and the significant challenges ahead. This is a good time to reform rather than in response to a crisis. *UNISON*

Rising contribution rates and falling employer participation were cited as a reason to change the status quo:

> Despite being relatively well funded, the SLGPS faces significant challenges under the current structure. Employer contributions required to meet the costs of the scheme have risen significantly in recent years, despite the introduction of the career average scheme in 2015. Indications from the English & Welsh cost cap calculations are that there is likely to be additional upward pressure on employer contributions from 2020. *Lothian Group*
>
> …the number of employers participating in LGPS in Scotland is falling so less resources are needed and greater consistency of practice can be achieved. *Robertson Group*
>
> As an employer working in the Scottish public sector where core funding has been reduced, managing the increasing costs of pension contributions reduces our ability to deliver front line services for the people of Scotland. *SEPA*

2. Benefits of scale

Some respondents said scale was a consideration for altering the status quo, particularly for small funds:

> The current structure probably suits the larger Scottish Funds better than smaller funds in terms of them being able to obtain lower investment fees and achieve economies of scale generally. Smaller funds also have the challenge of how to build in resilience in terms of succession planning and risk management.
>
> As a whole, the Scheme faces significant challenges – generating returns, keeping contributions affordable, dealing with complicated legislation and the demands for better standards from the Regulator. ESG, Voting, Cyber Security, Class Actions, Foreign Taxation, Accounting Standards are all further challenges. All of these issues will persist irrespective of the structure. They are, however, likely to be addressed more effectively in an enlarged structure – merger or collaboration - where scale would allow a specialist and better resourced service to be developed. *Falkirk Council Pension Fund*
>
> Retaining the status quo is likely to mean that inefficiencies will remain as most funds will not achieve the benefits of scale such as improved bargaining power, access to greater resources and reduced duplication of efforts in administration, governance, spending on advisers and fund management. Larger funds are also likely to be able to better access infrastructure investments. Maintaining the existing approach is therefore likely to mean that costs per member are likely to be higher than necessary…. Clearly any savings made or improvements achieved would need to outweigh any initial transition costs but all research to date would tend to support a move away from the status quo. *Robertson Group*
>
> There can never be absolute certainty over the total costs because investment returns depend on external factors. However, the evidence from the UK and across the world points to the benefits of scale. Scale gives greater investment clout, tackles fee transparency, enables in-house expertise to invest in new areas like infrastructure, better manages ESG issues and reduces duplication and cost. Change is always difficult and there are significant vested interests who will oppose change. Pensions are one of our members most important benefits and they need to be protected, not just today, but in the long-term. This may appear to be radical reform, but in the worldwide pensions sector, it will be seen as common sense *UNISON*

Adoption of best practice, consistency of approach and transparency were cited as reasons to change:

> It is also usually the case that regional funds are not aware of valuable approaches undertaken in other areas and therefore feel unable to apply them in their area. Greater centralisation would allow for greater implementation of best practice and for a much greater consistency of approach. Also, the existing structure potentially creates a key person risk as there is less available resource to cover key roles as well as budgetary and staff risk due to other competing local priorities. Consolidation should result in access to greater specialist resource, even if some of that resource needs to be regionally located. *Robertson Group*
>
> The present model is opaque with a lack of accountability and a lack of clarity about the day to day running costs of the fund. Any future model must therefore be more transparent and retain trade union representation at Board level and where possible at all appropriate stages of the process….There must also be improved transparency in the new schemes. Unite would want to see a system of reporting and monitoring of the costs associated with all aspects of managing the schemes. We would like to see a full breakdown of costs, prior to any alterations together with details of ongoing costs going forward to identify actual cost savings. *Unite*

3. Protection of deferred benefits

Protecting the deferred benefits of members by lowering costs was cited as a reason to change:

> … we must not lose sight of the fact that the pension fund belongs to its members. It is their deferred pay. Many of the members of the scheme have faced wage stagnation over the past decade and it is therefore important that the arrangements for their deferred pay is properly managed, scrutinised and where appropriate, altered in order to protect the future pension income of our members.
>
> One of the benefits, and possibly the main reason for altering the structure would be reduced running costs. Presently the management and administration of 11 separate schemes is an extremely costly exercise. Pulling the assets for investment into fewer schemes, with increased value will allow for reduced management costs, greater influence and deliver benefits from economies of scale. *Unite*
>
> It should be remembered that LGPS is there to pay members benefits many years ahead. LGPS forms a key component of local government and other Scottish employer's remuneration packages. For a number of years public sector has restrained pay rises across the public sector and as an employer LGPS is part of it is the package of benefits that attracts new staff. *SEPA*

4. Unsustainable for multi-fund employers

Multi-fund employers argued against the status quo because it was a poor fit with their operations; the risk of being treated as a closed employer; a high administrative burden, inconsistent treatment of staff; and an inability to fully participate in governance.[17]

[17] Evidence presented by respondents suggesting the SLGPS is unsustainable for multi-fund employers can be found earlier in this section: "How would respondents determine if the benefits of a local connection in governance outweigh the benefits of scale"

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

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

a) Cost of investing:

Original questions

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

What positive impacts did respondents see from promoting agreements between funds on investment costs?

Responses on the positive impacts from promoting cooperation on reducing investment costs included:

1. Marginal benefits or benefits to small funds only
2. Significant fee savings
3. Shared internal management
4. Avoids negative consequences of other options

Several respondents said collaboration in investing might make possible infrastructure investments that would have been unavailable to funds individually – these responses are examined in the infrastructure section for Option 2.

1. Marginal benefits or benefits to small funds only

Several respondents suggested there would be no benefits or only marginal benefits from promoting cooperation. For example:

> Financial savings through reduced fees, however, difficult to determine at this stage whether this is likely to be material. *North Ayrshire Council*
>
> Benefits in printing; consistency of practice and interpretation of [the regulations]. *SPDS*
>
> Some cost saving, though this is unlikely to be material for SPF. *SPF*

Some funds suggested that joint efforts to reduce investment fees would most likely be of benefit for smaller funds:

> Positive benefits, particularly for smaller funds are more likely to be shared and improved understanding of risk, and more efficient use of internal resources. *SPF*

> Given the size of the Strathclyde Fund currently there is potentially likely not to be further economies of scale which would secure further savings in terms of fees…*Renfrewshire Council*

> collaborative investing where increased levels of investment could potentially leverage reduced fees or provide access to a broader range of investment opportunities for smaller funds would be beneficial. *Highland Group*

> Apart from savings on investment costs, smaller funds would benefit in terms of access to shared resources to deliver better management of investment managers, better performance analysis and understanding of risk. *Children's Hearings Scotland*

> For collaboration to be successful there needs to be mutual benefits for all the Funds (e.g. a financial contribution from the smaller funds to enable the shared resource costs to be shared). Funds have to invest resources to work together at a variety of different levels. It is unlikely larger funds would benefit. *SEPA*

Others said cooperation would face limitations in scope, for example, to fund procurement, active fund management or alternative assets only:

> There should be some savings through joint procurement of investment managers and peripheral services (e.g. proxy voting, ESG advisors, etc.) Considerable work in this direction has already been done through the use of National Frameworks for services such as actuarial, investment consultancy and custodian services. *Falkirk Council Pension Fund*

> There could be some savings in fees through economies of scale though this must be considered in the context of the overall return on the Fund. *Comhairle nan Eilean Siar*

> … costs could be reduced due to joint procurement of investment managers, although probably only in active management or investment in alternative asset classes. *Dumfries and Galloway Council Pension Fund*

> The impacts will critically depend on the governance arrangements of the cooperation. For example, the greater the consistency in the way in which investment strategy is defined and implemented, the greater the potential fee savings. Currently, these decisions are all made by different funds and are influenced by different advisers. *Lothian Group*.

2. *Significant fee savings*

Many respondent said they thought joint agreements on investing could reduce costs across the SLGPS. Some respondents said that there was already significant joint efforts between funds:

> The Council understands there is already joint working between the 11 Funds, including procurement framework agreements, member communications and due diligence on investments. The Council is supportive of further joint working where possible and where this would achieve greater efficiency, improved costs or potential improved performance within the existing governance structures. *Renfrewshire Council*

> There is already strong cooperation and an excellent network across the SLGPS Funds which is used to share knowledge and best practice. Funds can also access the LGPS (UK) procurement frameworks to secure best value when undertaking procurements. *Highland Group*

> [Tayside Pension Fund] think this is potentially the largest area that could deliver improvements both in terms of costs and in quality of performance. Collaborative procurement

> across all investment services, based on incorporating potential for others to join if appropriate would ensure standardisation of investment fee rates (which may be an issue for smaller funds) and also cost sharing of generic requirements across all funds would also ensure consistency of information as well as removal of cost duplication. *Tayside Pension Fund*

> The Board believes that further collaboration in investing and administration between pension fund administering authorities has the potential to deliver significant benefits, not least the promotion of good practice. *Scottish Borders Council Pension Board*

> Any agreed investment, could also save time on due diligence work and save fund manager fees, given the cost structure that fund managers adopt which is based on overall investment size. *Shetland Islands Council Pension Fund*

> given the commonality of investment strategies, cooperation could deliver significant savings, when comparing with the true underlying costs which are currently being paid. Potential cost savings, and the sustainability of such savings, critically depends on governance. Cost savings could be achieved with external investment management, particularly in asset classes which are typically more expensive e.g. private markets and particularly where funds invest in 'fund-of-funds' arrangements. Funds are increasing investing in these more expensive areas. *Lothian Group*

> Increased purchasing power has the potential to lead to reduced investment costs as most investment managers have fee structures that are more expensive for smaller levels of investment. Agreement between funds could see greater sums invested in the lower cost fee range which would be beneficial to the funds…. A small number of comprehensive framework procurement agreements for fund managers and professional advisers might be a good start. *Orkney Islands Council Pension Fund*

As well as lower costs from procurement of external fund management and related investments services, respondents cited benefits such as greater asset diversification, improved returns to sale, staffing resilience and sharing of best practices.

> Collaboration and cooperation will give all funds the confidence to invest in a wider range of diversified assets and provide access to a wider breadth of expertise. *Scottish Borders Council Pension Fund*

> Savings on investment costs; ability to access a wider range of asset classes; improved implementation of strategy; improved investment manager management, better performance analysis and improved understanding of risk. *SEPA*

> Has the potential to improve investment returns through scale, if adopted. *Fife Council and Fife Pension Fund*

> Cooperation would allow best practice using existing structures and systems to develop over time. Collaboration can give access to a wider breadth of expertise. CIPFA

> Collaboration could provide greater staffing resilience and access to a wider spectrum of expertise. *Comhairle nan Eilean Siar*

3. Shared internal management

Some respondents suggested funds could make costs savings by sharing investment services or sharing internal managers:

> Further savings may be achieved if Funds are able to tap into an internal investment resource, although stringent regulatory standards and the need to remunerate such staff appropriately are potential barriers. *Falkirk Council Pension Fund*

> … Lothian's internal investment arrangements have delivered, and continue to deliver, significant savings of investment costs and, subject to governance, this resource could be utilised by others…The greatest savings could come from reducing external investment manager fees, particularly in more expensive asset classes and current fund-of-funds arrangements. Further savings could be made with internal resource from funds being utilised by others, facilitating in-sourcing of investment management functions. This could also bring wider governance benefits. *Lothian Group*

4. *Avoids negative consequences of other options*

Some respondents said cooperation would be beneficial because it would avoid negative consequences of structural change. For example:

> Risk to current funding levels would be minimized. The sound investment returns delivered by funds over many years would not be compromised. Nor would any differences which currently exist between funds, for example funding levels and rates of employer contribution require to be addressed. (This could of course be avoided through segregation of funds but would require enhanced levels of administration and reconciliation.) *CIPFA*

What negative impacts did respondents see from promoting agreements between funds on investment costs?

Several responses said there would be no negative impacts. Other responses cited opposition from existing stakeholders, set-up costs, governance difficulties, operating risks and concentration risks:

1. Stakeholder opposition
2. Set-up costs
3. Governance difficulties
4. Operating risks
5. Concentration risks

1. *Stakeholder opposition*

Stakeholder opposition to shared services or dilution of influence was cited.

> Potential for local elected members and/or trades unions to oppose shared service/promotion of co-operation so this would be detrimental. *SPDS*

> Loss of input at a local level maybe a concern. *Fife Council and Fife Pension Fund*

2. *Set-up costs*

Legal and other administrative set-up costs were cited.

> Setting up and drafting the initial agreements between various Funds, could be time consuming and expensive and may be difficult to achieve agreement. There could also be significant costs, delays and administration involved with getting revised investment processes put in place. *Shetland Islands Council Pension Fund*

> The drafting of agreements between funds could be time consuming and expensive while there could be significant transaction costs involved with getting a strategy in place. *Orkney Islands Council Pension Fund*

> Any collaboration would be required to be specifically set out and agreed through the appropriate governance structures. *Argyll and Bute Council*

3. *Governance difficulties*

Difficulties in governing the arrangements were cited:

> All parties would have to go through their own decision making and governance process… this could mean that investment opportunities are delayed or missed before a final decision and agreement is made. *Dumfries and Galloway Council Pension Fund*

> There could be tensions between investment strategies of different authorities. *Comhairle nan Eilean Siar*

> Lothian has concerns over the potential governance of greater cooperation and the ability for collaboration to achieve scale. Our experience of cooperation with other funds is that for this to work effectively, there needs to be similarity in the governance arrangements of the funds (e.g. delegation to officers to enable swift decision-making to take place). Without suitable alignment, willingness and resource, decision making ability could be adversely affected and arrangements may be inefficient and unsustainable. *Lothian Group*

4. *Concentration risks:*

The risk that scheme funds could be run by fewer fund managers were cited:

> Potential downside in concentrating more funds in one investment manager. Where currently several investment managers are involved in supporting funds across the LGPS there is the benefit of having a number of opinions and views and consequently reduced risk of poor advice impacting on funds. *Highland Group*

b) Governance:

Original questions

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

What positive and negative impacts did respondents see from promoting agreements between funds on governance?

Several respondents saw no impact or no significant impact on governance. Others gave responses which covered:

1. Alignment of interests
2. Coordination
3. Impact on governance resources

4. Dilution of governance
5. Avoid negative consequences of other options

1. Alignment of interests

Some responses suggested that the ability of funds to cooperate depended on the alignment of governance structures and the presence of benefits for all funds:

> Depends on the extent of the collaboration between funds. [Falkirk Council Pension Funds'] experience of collaboration with Lothian on infrastructure investing is that for this to work effectively there needs to be similarity in the governance arrangements of the two funds (i.e. delegation to officers to enable swift decision-making to take place). *Falkirk Council Pension Fund*
>
> Collaboration will be easier to achieve where underlying governance structures are similar and it can be demonstrated that all Funds involved in the collaborations will secure benefits. *Scottish Children's Reporter Administration*
>
> Lessons could be drawn from our experience of cooperation with Falkirk and Fife Pension Funds:
>
> - Development of relationships and trust has been a foundation of the cooperation.
> - The cooperation has evolved over the last 6 years.
> - The delegation of investment strategy implementation and selection of investment managers was the most fundamental change to Falkirk and Fife's governance to facilitate greater cooperation. This is uncommon in the SLGPS.
> - The Joint Investment Strategy Panel is in its very early stages and its success in terms of delivering cost savings has not yet been proven.
> - Pensions Committees and officers retain decision making for their respective fund based on advice from LPFI.[18] Therefore each fund needs to continue to retain sufficient resource with knowledge and experience to make such decisions and to maintain 'professional investor' status. *Lothian Group*
>
> Arrangements involving multiple funds will be more complicated than the status quo…. there needs to be benefits for all funds in the collaboration. The larger funds may not benefit. *SEPA*

2. Coordination

Coordination of decision making was as a potential limitation to cooperation:

> The difficulty of coordinating investment decisions, often to tight market driven timescales could be a potential disadvantage. *CIPFA*
>
> No negative impacts, but the need to co-ordinate activity and decision-making could be a complication until such arrangements bed down. *Tayside Pension Fund*
>
> Initial discussions on the various aspects of any agreement would be a time consuming process. This process could be onerous and issues difficult to resolve due to the complexity of any agreement and the number of parties involved. All agreements need to be maintained, updated, reviewed etc.to everyone's satisfaction. *Shetland Islands Council Pension Fund*

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[18] LPFI Limited and LPFE Limited are two wholly owned subsidiaries of the City of Edinburgh Council to administer the Lothian and Scottish Homes pension funds.

> Having the experience of collaborating with Lothian, the reality is that decision making on collaborative matters is more complicated than non-collaborative matters. This is not unexpected. Reaching definitive positions or simply organising meetings to suit collaborators can be challenging). The more Funds involved then the more complicated it becomes. In other words, there are limits to the collaborative model. *Falkirk Council Pension Fund*

> There could be negative impacts in terms of lack of co-ordination, delays in decision-making if underlying governance structures are not aligned or there are too many collaborative partners. *Scottish Children's Reporter Administration*

> There could be difficultly changing governance structures so that quick decisions can be taken on investment opportunities. *Highland Group*

> Could slow down decision making and processes the more partners are involved in any one collaborative model. Logistically less manageable the more partners are involved. Could take a long time to move funds forward to voluntarily work in this way. Resistance to change could slow things down even further. *Fife Council and Fife Pension Fund*

> As decision making would be retained by funds, there can be uncertainty of whether the cooperation will produce results. Without clear governance arrangements, cooperation could: make decision making more complicated and slower; introduce additional layers of governance; be hindered by the lack of resource in some funds; and lack sustainability. *Lothian Group*

3. Impact on governance resources

Responses said collaboration could increase governance overheads or alternatively, win synergies from existing resources.

Increase governance requirements:

> Collaboration does not remove any governance overhead from individual funds. *Scottish Borders Council Pension Fund*

> Collaboration requires resources in the form of staff to be available to work together, increasing administration costs. *SEPA*

> Agreements [are required] to be documented and maintained – once they lapse they are an easy target for auditors to criticise and are therefore a governance risk. *Orkney Islands Council Pension Fund*

Synergies from existing resources via sharing of best practices, greater scrutiny of investments, reduced duplication and reduced key person risks:

> A wider range of individuals scrutinizing and challenging investment decision should lead to better outcomes *CIPFA*

> Collaboration may encourage the sharing of good practice although this is already widely shared nationally at officer level. *Scottish Borders Council Pension Board*

> Would help encourage best practice in relation to governance and learning from each other beyond that which exists at present. *Fife Council and Fife Pension Fund*

> Reduced duplication of governance effort. Improved collective governance of the scheme, creating a more collaborative culture across funds. *Tayside Pension Fund*

> There would be opportunities for funds to share resources; reduce costs and learn from each other, developing and implementing best practice. *Falkirk Council Pension Fund*

> Support between funds could provide cover for the “key person” risk sometimes incurred by funds. *Dumfries and Galloway Council Pension Fund*

> Smaller funds could benefit from the scale of larger partners and could ‘buy in; to their resource and expertise *Fife Council and Fife Pension Fund*

4. Dilutes governance

Some respondents suggested the new arrangements risked greater complexity and reduced governance as a result:

> Initially introducing a new layer of cooperation and setting up agreements with other Scottish LGPS Funds would involve added governance at officer and committee level due to the new nature of the agreements and its complexity. Once the agreements are in place and operating it would depend on the agreement itself but collective governance could actually reduce individual fund governance. *Shetland Islands Council Pension Fund*

> More complex arrangements will be required to ensure transparency where investment decisions may relate to more than one administering authority. *Comhairle nan Eilean Siar*

> If collaborating with another Fund on an investment opportunity other Funds will have to make decisions quickly in order to access a particular investment opportunity. This may require delegated authorities to be set up and decisions would then be reported to Committee at a later date. *Highland Group*

> Fund governance at a local a level would potentially be diminished as a result of funds reaching agreement on investment. *Orkney Islands Council Pension Fund*

> There may be a perceived dilution of elected member involvement and influence in favour of officers. *Argyll and Bute Council*

5. Avoids negative consequences of other options

Some responses said collaboration would avoid negative consequences of other options to governance, including costs, loss of local input and retention of expertise:

> Probably a more cost effective change to governance than pooling or merging. *Fife Council and Fife Pension Fund*

> Links to local accountability would be maintained and the recent development to establish Pension Fund Boards would be allowed to reach its full potential. Collaboration will allow the retention of local expertise in the Finance and HR functions providing depth and resilience across Scotland, particularly in smaller authorities, which would otherwise be lost. Ensures that value would not be lost through adverse timing of sales and the repurchase of assets as funds restructure. Risk under this option is therefore avoided when compared to formal restructuring. *CIPFA*

> Collaboration would mitigate key person risk in smaller councils which would arise as a direct result of other options *Scottish Borders Council Pension Board*

c) Operating risks

Original questions

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

What positive impacts did respondents see from promoting agreements between funds on operating risks?

Respondents said promoting agreements between funds would have no impact; could promote risk sharing or that such cooperation would avoid the negative consequences of other options.

1. *No impact on operating risks*

Several respondents saw no significant impact on operating risks from collaboration, subject to qualifications:

> No material impacts if collaboration is undertaken on a voluntary basis with each fund retaining responsibility for its own investment decisions. *Scottish Borders Council Pension Fund*
>
> No significant impact identified in operating risks if robust monitoring arrangements are put in place. *East Ayrshire Council*
>
> Operating risks should be dealt with in the same way by administrators as now. *Scottish Fire*
>
> A new contract or agreement between funds will involve, at the outset, new operational controls and risks. This will require additional work initially but after that there should not be any difference to the ongoing operational risk, if anything there should be an improvement to operational risk, in particular key man risk. *Shetland Islands Council Pension Fund*

Some responses said that collaboration was in fact the status quo or argued that the impact on operating risks was limited.

> Significant voluntary cooperation already exists between LGPS funds. Best practice is already shared through the Officer forum [of] the IGG which is attended by representatives of all Scottish Local Authority Pension Funds .Funds already access a range of services through nationally agreed procurement frameworks. *Scottish Borders Council*
>
> Responsibility and accountability could become unclear and/or complex. Voluntary cooperation already exists with funds across Scotland therefore some of the risks are known and have been mitigated to a certain extent. *Fife Council and Fife Pension Fund*
>
> Collaborations can evolve at the pace most suited to the needs of the Funds concerned, but given the lack of incentive for change may lack impetus. *Falkirk Council Pension Fund*

Others said that collaboration would need to be systematic to produce additional benefits to operating risks:

> Collaboration under this option is voluntary, so Funds will be under no compulsion to collaborate and some Funds will be more interested than others. *Falkirk Council Pension Fund*

2. *Sharing of resources and risks*

Risk sharing with larger funds or other funds was cited as having a positive impact on operating risks. For example:

> For medium sized and smaller funds, collaborating with other larger Funds will assist with risk management, including key man risk and general resilience. *Falkirk Council Pension Fund*

> …there may be benefits if an approach could be adopted which shared risk across several pension funds. *Renfrewshire Council*

> …depends on what the collective agreement is and how it is set out, but a collective management of risk must benefit operational risk. *Shetland Islands Council Pension Fund*

Sharing of experience, expertise, resources, best practices and processes were cited as having a positive impact. For example:

> Allow funds to draw on the specific expertise and experience of other funds. *Dumfries and Galloway Council Pension Fund*

> More collaboration with the Funds can only be a positive thing by learning more from each other and would go some way to eliminating duplication of effort, in particular with regard to administration matters. *Shetland Islands Council*

> Increase collaboration in Pension Administration could have a positive impact above that already in place. All administering authorities now operate on the same administration system which…could lead to increased synergies around documentation and testing of system upgrades resulting from changes to regulations. *Scottish Borders Council Pension Fund*

> There would likely be a positive impact on both the risk management process (more skilled resources) and control of risks e.g. key person risks and improved resilience. *Children's Hearings Scotland*

> Cooperation could reduce key-person risks faced by funds, particularly the smaller funds, and hence help to develop more sustainable resources. *Lothian Group*

3. *Avoids negative consequences of other options*

Some responses said cooperation would avoid negative consequences of other options to operating risks. For example:

> By maintaining the existing SLGPS structure but promoting agreements between Funds, there is no risk to funding levels or investment performance but could be potential cost benefits. *Highland Group*

> Funds would retain their own investment strategies relevant to their local fund requirements, funding levels, risk appetite. Local expertise would be retained e.g. staff with knowledge and expertise in pensions, investment, and an understanding of pension benefits this is an asset within the Local Authorities. This would potentially be lost in a merger arrangement. *Fife Council and Fife Pension Fund*

> Collaboration would allow the continued diversification of funds and would ensure that strategic asset allocations remained aligned to funding levels reflecting the different positions

> across 11 funds… There would be no need to develop new asset allocation strategies for segregated funds linking risk appetite, required return and varying funding levels. *CIPFA*

What negative impacts did respondents see from promoting agreements between funds on operating risks?

Respondents said cooperation could increase operating risks if: these risks did not scale well; governance agreements were not effective; and cooperation exposed funds to new risks

1. *Operating risks will not scale well in cooperation*

Responses said that cooperation might lead to only limited reduction of key person risks and lead to a loss of administrative capacity

> The reduction in key person risk is limited insofar that a smaller fund cannot expect a larger fund to be resourced simply to meet any adverse circumstances that it may encounter. *Falkirk Council Pension Fund*

> Funds may shrink administration teams to the point of unsustainability – they are already lean. *SPDS*

> Potential risk of loss of experienced staff if one organisation takes the lead. *East Lothian Council*

Others suggested cooperation would require additional resource to be assigned to manage operating risks, or not lead to a reduction in effort:

> A collective agreement will bring at its outset additional issues and work to satisfy risk management. Once the agreement is in operation it will require to be maintained and reviewed which will also require additional resources. *Shetland Islands Council Pension Fund*

> High level of specialist skills and knowledge would need to be retained across the 11 Funds so there is still duplication of effort and systems. *SEPA*

> There may be an increased workload in establishing, monitoring and then maintaining agreements which will be time limited and subject to negotiation. *Orkney Islands Council Pension Fund*

Operating risks were cited as limiting the scalability of cooperation

> May be slow or difficult to ensure operational consistency and to reach a point where collaborative partners are progressing operationally to similar timescales and in a consistent manner and using a similar 'language'. Each partner will have competing priorities which might be different for each organization…There is a limit to the size of a collaborative model e.g. the current collaboration between Lothian, Falkirk and Fife would be difficult to expand to add yet another partner. *Fife Council and Fife Pension Fund*

2. *Effectiveness of cooperation agreement*

Governing the cooperation arrangement was cited as potentially increasing operating risks. This included governance arrangements that failed to manage disagreements, for example:

> ..The risks will depend on the governance of the cooperation. Lothian has concerns over the potential governance of greater cooperation and the ability for collaboration to achieve scale. Our experience of cooperation with other funds is that for this to work effectively, there needs to be similarity in the governance arrangements of the funds (e.g. delegation to officers to

enable swift decision-making to take place). Without suitable alignment, willingness and resource, decision making ability could be adversely affected and arrangements may be inefficient and unsustainable *Lothian Group*

Issues of liability if performance less than expected for lead fund. *East Lothian Council*

Formal agreements need to be documented leading to additional legal costs. There is the potential for disagreement and challenge arising from service failure or adverse investment returns. This could increase the risk of legal challenge and require formal dispute resolution procedures. *CIPFA*

There would need to be clear agreements about responsibilities and how any disputes about performance, or any service failure, would be addressed. *Comhairle nan Eilean Siar*

Negative impacts if the collaboration breaks down, key staff with investment expertise at the Fund leading the collaboration leave, responsibilities at the funds collaborating are not clearly defined which creates tensions. *Highland Group*

3. *New risks from cooperation*

Responses said cooperation would expose funds to new risks. For example:

Risk that under a collaborative investment model inappropriate resilience is placed upon the work of others and the necessary diligence on behalf of individual funds does not take place with sufficient rigor. The effectiveness of any diligence process is reliant upon funds having a clear understanding of the key features and risks associated with investment products. *CIPFA*

Move away from undertaking effective due diligence at a local level. *Fife Council and Fife Pension Fund*

Lothian's FCA authorisation means that it is exposed to additional regulatory risks…. Cooperation could bring additional operational risks…: make decision making more complicated and slower; introduce additional layers of governance; be hindered by the lack of resource in some funds; and lack sustainability. *Lothian Group*

d) Infrastructure:

Original questions

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

What positive impacts did respondents see from promoting agreements between funds on infrastructure investments?

Comments on the positive impact of cooperation on infrastructure investing covered the following areas:

1. Changing the status quo requires incentives

2. Removes costs and expertise barriers
3. Will benefits smaller funds most

1. Changing the status quo requires assistance or incentives

Some responses said that cooperation on infrastructure investing was in fact that status quo, or that the level of infrastructure investment in the scheme depended most on the investment strategies of individual funds rather than the option to collaborate. For example:

> In practice this arrangement is already working effectively with respect to infrastructure. *Scottish Borders Council Pension Fund*

> Increasing investment in infrastructure would be dependent on the investment strategies across each of the funds since investment in assets flows from this. There would be a question for each fund as to whether increasing investment in infrastructure was the right thing to do for the fund. It would depend as to whether this was an objective linked with the investment strategy as to whether this would be a desired outcome. *Fife Council and Fife Pension Fund*.

The Scottish Government may have to provide guidance or model agreements before cooperation could have an impact on funds ability to invest in infrastructure. For example:

> Proper guidance / regulation to protect funds are needed. *SPDS*

> If the Scottish Government established a model agreement for funds to use for collaboration in infrastructure investment and had available suitable investment opportunities then promoting agreement between funds should lead to an increased ability to invest in infrastructure. Suggesting agreements are made on its own is unlikely to have much impact. *Orkney Islands Council Pension Fund*

2. Removes cost and expertise barriers

Cooperation could raise investment in infrastructure by removing barriers such as high costs or lack of expertise:

> Jointly-commissioned consultancy reports, due diligence and legal review could reduce costs and facilitate some additional investment. *Glasgow City Council*

> An agreement between Scottish Funds on an infrastructure product would certainly be beneficial for most funds, as it would remove certain barriers that have prevented them from investing, such as lack of expertise in this area, the increased due diligence, governance required and the level of investment. An agreement would certainly give Scottish Funds the ability and opportunity to invest if it was as seen as an appropriate investment within their investment strategy. *Shetland Islands Council Pension Fund*

> Scottish Water has had some experience of this option in recent years through its participation in the Lothian Pension Fund, which, through its FCA authorised company advises other funds and works with them to address key staff risks and develop trust within the current structure. Collaboration with funds that have similar investment objectives and principles is positive in that resource, knowledge and costs can be shared. The arrangements are expected to evolve and for benefits to become available from greater investment scale as trust grows and the funds are prepared to enter into larger parallel investments. *Scottish Water*

> The cooperation between Lothian and other LGPS funds (Falkirk, Fife, Scottish Borders and Northern Ireland) has enabled investing in greater scale and for other funds to benefit from

the commercial advantage of Lothian's in-house team. This element of the cooperation with Falkirk Council Pension Fund has been in place for approximately 3 years and has facilitated investment of £100 million into around 20 different investment vehicles. The cooperation gives all Funds involved greater scale and access to opportunities that are unlikely to have been available otherwise. *Lothian Group*

Ability for funds without experience in alternative asset classes to benefit from the experience and expertise of others. *Tayside Pension Fund*

Co investment provides the opportunity to share legal, technical due diligence costs. *CIPFA*

Standardised and potentially better quality information to facilitate more informed, and better decision making Potential financial savings, and facilitating wider diversification across asset classes. *Tayside Pension Fund*

Promotes greater understanding of the asset class; brings scale to prospective investments; opportunity for reduced fees; better alignment between the actual investment and Fund objectives; reputational dividend if Funds are seen to invest in UK economy. *SEPA*

Increased diversification for pension funds and achievement of a political aspiration to see LGPS Funds investing in Scottish infrastructure projects. *Orkney Islands Council Pension Fund*

3. *Will benefit smaller funds most*

Small funds were cited as the greatest beneficiaries of cooperation, some suggesting benefits to large funds may be marginal. For example:

May make it easier for smaller funds to invest in infrastructure projects. *Scottish Children's Reporter Administration*

Agreements may allow smaller funds to gain access to infrastructure in a cheaper manner than the traditional Fund of Fund route. *Falkirk Council Pension Fund*

This should not have a significant impact on the existing ability of Funds to invest in infrastructure, except for small Funds. *Comhairle nan Eilean Siar*

This may benefit smaller funds to share the knowledge and expertise of those already investing in large infrastructure projects. From an [Strathclyde Pension Office] perspective there would be little impact aside utilizing a potentially larger knowledge base… There may be marginal benefit to larger funds and may support barriers for smaller funds to consider infrastructure investments. *East Ayrshire Council*

Ability to develop a more diverse portfolio of infrastructure investments allowing smaller funds to participate in as part of a pool where previously might not have been able to. *Scottish Fire*

Smaller funds would have access to a wider range of investment opportunities on a cost effective basis. A recent good example is the benefits that have been gained by Falkirk and Scottish Borders Council through collaboration with Lothian Pension Fund in a range of infrastructure based investments. Co investment provides the opportunity to share legal, technical due diligence costs. *Scottish Borders Council Pension Fund*

What negative impacts did respondents see from promoting agreements between funds infrastructure investments?

Comments on the negative impacts of cooperation on infrastructure investing covered the following areas:

1. Small funds unable to participate
2. Non-local investing
3. Governance problems
4. Private-public mismatch

1. Small funds unable to participate

Some respondents suggested that small funds may lack the resources to jointly invest. For example:

> No negative impacts other than local resource requirement not to be underestimated for smaller funds and the need to find a willing collaborative partner. *Falkirk Council Pension Fund*

2. Non-local investing

Collaborative investing could lead to concentration of risks or diversion of investments away from local investments some respondents said. For example:

> Impact on local community and economy may be detrimental. *SPDS*

> There is an increased collective risk and reduced diversification if many of the Scottish Funds invested in the same agreement with the same fund manager; if the returns were poor all of the funds would suffer. This is a greater risk the fewer opportunities there are. *Shetland Islands Council Pension Fund*.

3. Governance problems

Respondents said joint investments in infrastructure would raise governance issues. Complexity of administration and governance could lead to limitations of scalability in cooperation. For example:

> .. the governance of such collaboration is complex. All funds in the arrangement need to continue to be resourced appropriately to make decisions for their respective fund beneficiaries. *Scottish Water*

> While not a negative impact the complicated nature of these investment has required Lothian Pension Fund to set up an FCA registered company which manages the co investment process. *CIPFA*

> …without clear governance arrangements, cooperation could make decision making more complicated and slower; introduce additional layers of governance; be hindered by the lack of resource in some funds and lack sustainability. *Lothian Group*

Governance would have to allow for the potential of some parties interests taking precedence over others or investments being made for non-financial reasons. For example:

> Potentially local interests could take priority over return and liquidity though this would be a breach of fiduciary duty. *Highland Group*

> It is possible that both the duration and returns from an infrastructure investment are not sufficiently attractive to merit the pension fund making an investment on purely financial grounds. Also, if the investment opportunity is in a key project in the local area the decision makers judgement may be clouded by a desire to see the project delivered for reasons other than the investment return. *Orkney Islands Council Pension Fund*

> Such cooperation initiatives could put undue pressure on funds to invest in infrastructure. This is not necessarily in the best interests of members and employers…The governance relating to infrastructure investments should avoid conflicts of interest, particularly in relation to 'local' investments.

4. Private-public mismatch

One response suggested cooperation in infrastructure investing could lead to a mismatch between private and public sector interests:

> The merits of an initiative that appears to promote public sector infrastructure investment opportunities to private sector investors, while at the same time encouraging public sector pension schemes to go out and seek investment opportunities from across the private sector is questionable. *Orkney Islands Council Pension Fund*

e) Respondents additional comments about Option 2 and respondents explanations for their preference for Option 2

This section summarises respondents additional comments on Option 2 and also includes relevant comments from Question 5a 'Which option does your organisation prefer'.

Arguments in favour of Option 2: Cooperation

Additional arguments made in favour of cooperation beyond those already presented earlier were:[19]

1. Existing cooperation between funds shows this is a viable option
2. Additional cooperation requires frameworks, incentives or assistance
3. Cooperation preserves existing features of the SLGPS or avoids features of other options

1. Existing cooperation between funds shows this is a viable option

Many respondents said that participants were good at cooperating, citing existing initiatives, willingness to continue, and potential benefits as part of their preference for this option:

> SPF has carried out joint due diligence with other funds on some investments. Introduction of LGPS 2015, and the associated member and employer communications, was a large-scale collaborative exercise between all the Scottish funds. There is undoubtedly scope and willingness to build further on these initiatives. *SPF*

> Significant co-operation between the Scottish funds and the wider LGPS network already exists. LGPS (UK) National Frameworks are in place and are widely used for a range of services including actuarial, investment consultancy, stewardship, global custody, performance and cost monitoring, legal, transition management and third party administration services. Scottish LGPS framework agreements have been put in place for portfolio management, member tracing, and scheme administration. *Tayside Pension Fund*

[19] Responses also revisited the advantages of cooperation given earlier and these can be seen in the sections on investment costs, governance, operating risks and infrastructure investment.

> Scottish LGPS framework agreements have been put in place for portfolio management, member tracing, and scheme administration. Much good joint work was undertaken in 2014 and 2015 to promote the new Career Average Version of the Scheme including agreeing web content and using multi media. There is scope and willingness to foster further collaborations as opportunities arise. *SEPA*
>
> NESPF have long been participating members of the CLASS (Computerised Local Authority Superannuation System) group which was formed to allow public sector pension schemes to work together with a single software provider to ensure LGPS requirements are delivered with development cost shared amongst the group. CLASS is a successful public/private partnership that benefits from regular collaboration amongst the 11 Scottish Funds. Along with Strathclyde Pension Fund, NESPF has assumed an active role on the Testing Working Party, one of several collaborative working parties within CLASS, which focuses on testing system development delivered in software releases. Officers remain committed to engaging and supporting further participation in these, and similar, beneficial CLASS activities. *NESPF*
>
> … Highland Council Pension Fund would consider collaborative agreements to access infrastructure alongside other options for alternative asset investments but the basis for an investment would depend on whether an investment offered the return, risk and liquidity profile which was aligned to our investment strategy in order to maintain the existing funding level. *Highland Group*
>
> Whilst the other Scottish funds may not enjoy the same benefits of scale as SPF, they do appear to be achieving their objectives. The scheme does face significant challenges in the current, difficult pensions environment, and funds will need to adapt to address these. There are extant examples of how the other options considered in this consultation can assist with this. These include: collaboration between all the funds to introduce the LGPS 2015 scheme, the joint Lothian and Falkirk initiative on infrastructure investment, the creation of a pooled investment vehicle for Scottish real assets currently being developed by Scottish Futures Trust.
>
> These are all recent developments which have occurred organically within the existing LGPS structure rather than by any form of enforced direction or change of structure. There is undoubtedly more scope for further development of these and similar initiatives within the current structure, and this should be encouraged and actively supported for the benefit of the funds and their members and participating employers.
>
> Future development of the structure may also involve pooling or merger of funds but this should only occur where individual funds agree that this would be to the benefit of their members and employers. Smaller funds should give serious consideration to these options. SPF

Areas not covered by existing cooperation that could be pursued were cited:[20]

Administrative activities such as publishing:

> There are some larger administrative activities which could be done differently, working more collaboratively, resulting in reduced costs e.g. annual benefit statements and reduced printing costs. *Dumfries and Galloway Council Pension Fund*

Joint procurement of systems:

> [Aquila Heywood Altair Pension Administration] is used by all funds in Scotland yet there is no national framework in place. Each fund has its' own individual contract based on Heywood

[20] Includes responses relating to cooperation given in Question 5 (b) "What other options should be considered for the future structure of the LGPS? And 5 (c) "What would be the advantages and disadvantages of these other option for funds' investment costs, governance, operating risks and ability to invest in infrastructure"

charging model meaning that smaller funds pay more per head. Potential to have a more consistent costing model and offering from system. *SPDS*

Member education:

There is currently no provision in place for educating members about their LGPS benefits. This used to be a service provided free of charge to TPF members by Prudential (one of the AVC providers). With increased cooperation between funds there could be the potential to introduce shared resources for providing education about the LGPS fund to members. *CI-SSSC*

Investment opportunities; procurement; ESG & governance; administration:

The Scottish LGPS has established communications networks between funds (both investment and administration), but current focus is largely on information sharing and problem-solving rather than structural development. [Tayside Pension Fund] would welcome the opportunity to collaborate in areas such as investment opportunities; procurement; ESG & governance issues; administration. *Tayside Pension Fund*

2. *Additional cooperation requires frameworks, incentives or assistance*

Some respondents believed incentives, compulsion, frameworks or other assistance would be necessary to yield the full benefits of collaboration. For example:

Further support should be provided to Funds to help increase/promote collaboration and improve efficiency. *NESPF*

Some reorganisation … would be required in order to support co-ordinated development. This might include the following:

- development of a forward-looking programme to consider potential initiatives such as: joint investment, including in infrastructure; joint or framework procurement; and joint or shared diligence
- joint engagement on environmental, social or governance issues
- shared administration and communications.
- a regular, formalised meeting of fund conveners
- adding resource at a Scheme Advisory Board or cross-fund level, as well as in some instances at fund level
- establishment of more localised “hubs” to consider structural and investment matters – potentially 3: for the North, West and East of Scotland.

SPF would be happy to support, participate in and, where appropriate, lead such initiatives. *SPF*

The consideration is whether this happens organically to build upon the co-operation that already occurs or whether more formal arrangements should be put in place. *North Ayrshire Council*

Approaches to date seem to have been relatively informal which results in a degree of uncertainty over their future persistence so a more formal structure may be of value to assist with planning as well as the distribution of costs and returns. To date this sort of co-operation has been pretty limited despite its obvious benefits which would suggest that without strong vision and direction it will remain something of an outlier which would suggest that greater structure and compulsion is needed to really drive change. *Robertson Group*

A collaborative agreement between Scottish Funds on infrastructure would open up this type of investment to many of the Scottish Funds that could not invest in this asset class individually. Scottish LGPS Funds have worked together before on projects, so an agreement

> on an infrastructure product is certainly a realistic option, which would allow some of the Funds to get access to an infrastructure investment. *Shetland Islands Council Pension Fund*.
>
> It…brings a requirement for like-minded partners to work together with effective governance in place, to exploit the scale of efficiencies available which may not be practical, achievable or sustainable across all funds on a voluntary basis. *Police Scotland*
>
> The Scheme Advisory Board (SAB) has been in place since 2015 and has provided useful guidance to LGPS funds on fiduciary duty and other area. The SAB is also involved in developing system to ensure consistency of LGPS cost information. If there was greater investment in SAB, they could develop their role coordinating data to be shared across the funds leading to efficiencies and sharing of best practice. *Highland Group*

Some respondents suggested cooperation should only be voluntary or that incentives were preferable to compulsion. For example:

> There are already examples where administering authorities are collaborating and it should remain open to authorities to work together where there are tangible advantages in doing so. *Comhairle nan Eilean Siar*
>
> Collaboration already exists and that extending this is likely to be beneficial. Promotion of co-operation should be done through a framework as opposed to rigid legislation. There should be exploration of an incentive scheme to encourage the cooperation. *SPDS*
>
> …It is still too early to have a proper understanding of the benefits that this way of working can deliver. This has been a voluntary change in the model for managing the Fife fund and the Fife Committee believes that fiduciary duty would be compromised by moving to any enforced model *Fife Council and Fife Pension Fund*

3. Cooperation preserves existing features of the SLGPS or avoids features of other options

Many respondents said the preference for cooperation was informed by a desire to preserve current scheme features or avoid of the consequences of other options. These included:[21]

Lack of appetite for change - for example:

> Taking into account the views of Councils, funds and professional associations on board, particularly those views coming from council Directors of Finance, there is little demand for change being suggested by COSLA's membership at this point. Instead there is more interest in building on existing good practice and collaboration, where mutually agreed by funds with their Pension Committees. COSLA suggests therefore that the SAB could usefully focus on building on existing mechanisms for sharing and promoting good practice and improved collaboration amongst the 11 pension funds. This could be done in a way that provides tangible benefits to all parties, whilst continuing to ensure the fiduciary duty of the 11 Funds is supported. *COSLA*
>
> The Council believes that Option 2 in effect represents the status quo and is the most suitable option; and would encourage Funds to work cooperatively on a voluntary basis in addressing specific issues which affect all Funds. *Renfrewshire Council*

Existing scale benefits, governance arrangements, funding positions and management of risks:

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[21] Respondents also went details into these issues in the sections for Options 1, 2, 3 and 4

Tayside Pension Fund (TPF) already enjoys considerable benefits of scale in terms of cost which is demonstrated by the independent annual reviews undertaken by Audit Scotland. TPF has in place an appropriate and effective governance structure and risk management processes. *Tayside Pension Fund*

there is no indication currently that the activities of the 11 Scottish Pension Funds are failing to ensure sufficient income from investment to maintain pension benefits. As each Fund employs the services of an actuary, auditing of Funds' activities is carried out annually to ensure that investment is generating the return needed to provide the necessary benefits to pensioners. *South Ayrshire Council*

The Committee also believes that there is no place for imposed wholescale structural change in relation to management of the LGPS as this takes no cognisance of risks/benefits/stability of individual funds. It is not clear that any of the other proposed changes would alter the opportunities to be gained from working collaboratively. However, there may be a limit as to how many partners can collaborate before a partnership becomes too unwieldy, so there may be additional economies of scale from merging/pooling. *Fife Council and Fife Pension Fund*

The Scottish LGPS have good funding positions and have proved to be a long term success but there are many challenges within the pension domain. This is not an unusual situation and does not require any sudden changes to the scheme but the cooperation between funds could be enhanced with more collaboration on some of the more challenging issues. *Shetland Islands Council Pension Fund*

Uncertain evidence of benefits of other options:

The Scottish Borders Council Pension Fund Board believes that the case for change to the LGPS in Scotland has not been made. More work would have to be done to evaluate the benefits and risks associated with structural change in the form of pooling or merger before this could seriously be recommended to Scottish Ministers. *Scottish Borders Council Pension Board*

The Council recognises that some marginal cost savings could potentially be delivered by fewer larger funds replacing the current arrangements over the longer term. Evidence to support this view is however limited and there is presently no strong reliable evidence base to verify this position….The Council believes the results of the E&W LGPS changes must be given time to bed in and a proper evaluation of the benefits and disadvantages of such change needs to be undertaken before any such similar experiment is undertaken in Scotland. *Scottish Borders Council*

The fund is of the opinion that as yet there is insufficient evidence to suggest that the pooling exercise currently being undertaken in England and Wales has generated the necessary savings to justify the costs incurred in the creation of the pools. The fund has concerns that there is no overriding evidence to suggest that investment performance will be enhanced through the operation of pooled or merged funds. There are also concerns that either of these options (3 or 4) would reduce the level of local control and governance. *Dumfries & Galloway Council Pension Fund*

The Fife Pension Fund Committee remains open minded about possible changes in the future but believe that any future changes must be based on a significant body of evidence that leads the Committee to believe that the Fife pension fund members would be better served by any different model. However, at this point in time the Committee believes that there is not enough detailed evidence to suggest that any other model would result in better performance or management of the Fife Pension Fund. *Fife Council and Fife Pension Fund*

Potential high costs or high risks of other options:

[Cooperation] carries the least level of risk. The other options, particularly merging the funds, carry significant known and unknown risk and there is no evidence presented to justify this radical change and heightened risk. *Argyll and Bute Council*

> As noted above Council officers who advise and administer the pension fund are also engaged in the wider corporate management of the Council. This cost effective arrangement also avoids key person risk to the pension fund and ensures the Council has the capacity to manage its financial affairs effectively. Structural reform whereby senior finance staff would TUPE[22] transfer to new bodies would pose an unacceptable risk to the management of the Council. *Scottish Borders Council*

> The Tayside Pension Fund has a low contribution rate based on the localised asset and liability profile of the fund, its underlying funding position and bespoke investment strategy. There is no guarantee that any future investment strategy determined at a larger scale would sustain this. The risk is that a change in structure could result in a rise in employer contributions which in the long term could result in reduced benefits for members. As pensions are a long-term undertaking, any structural development should be clearly focused on the long-term sustainability. *Abertay Housing Association*

> In the absence of evidence to the contrary the SBCPF board is of the view that such change would be likely to have a detrimental impact on performance and pensioner confidence and for this reason believes that if change is required this should come in the form of **option 2** with closer cooperation being encouraged between funds. This has the potential to deliver a number of positive benefits as set out in the consultation response. *Scottish Borders Council Pension Board*

Need to wait for existing initiatives to bear fruit. For example:

> Fife Pension fund has recently entered into a collaborative partnership with both Lothian and Falkirk Pension Funds and this has been progressed based on a body of evidence collected over a substantial period of time and based on an evidence based business case. This partnership has been agreed on the basis that those who govern the pension fund believe that it is in the interests of both the pension fund members and the employers and for the overall governance of the fund. There is still some way to go to really maximise the benefits from this approach and the Pension Fund committee believes that these benefits should first be fully explored and exploited before further change is considered. *Fife Council and Fife Pension Fund*

Arguments against Option 2: Cooperation

Additional arguments made against cooperation beyond those already presented earlier were:[23]

1. Problems with scaling cooperation
2. Requires internal investment management or separation of governance
3. Multi-fund footprint preserved
4. Consolidation has greater benefits

1. Problems with scaling cooperation

[22] A transfer under the Transfer of Undertakings (Protection of Employment) Regulations 2006

[23] Responses also revisited the advantages of cooperation given earlier and these can be seen in the sections on investment costs, governance, operating risks and infrastructure investment.

The Lothian model was cited both as an example that cooperation was a workable option and as showing that cooperation didn't scale well, both are presented here:

Lothian model demonstrates benefits of cooperation

> The Lothian model and current collaborative projects between Scottish Funds demonstrate that increased collaboration can be achieved voluntarily and the real benefits that can be achieved under the current status quo structure. *NESPF*
>
> [Falkirk Council Pension Fund's] experience of entering into a collaborative agreement with Lothian has been extremely positive enabling the Fund to make £100m worth of investments into around 20 different vehicles. *Falkirk Council Pension Fund*
>
> There would appear to be scope for collaboration to be increased. The benefits of existing collaborations, including the Falkirk, Lothian and Fife collaboration, could be evaluated to provide evidence to support further change. *Scottish Children's Reporter Administration*
>
> Fife has recently [reviewed] a collaboration arrangement with Lothian and Falkirk Pension Funds based on research, business case and evidence. It is believed that the collaboration promotes the interests of the pension fund members and the employers and is beneficial for the overall governance of the fund. *Fife Council and Fife Pension Fund*

Lothian model has scaling problems:

> The simple logistics and co-ordination of stakeholders in order to make decisions seems to grow complexity at an exponential rate, to the degree that Lothian Pension Fund estimates it has reached the limits of a workable governance structure when collaborating with only two other funds. Making investment decisions requires 12-15 people from different authorities to reach an informed agreement within the joint investment strategy panel (a small sub-set of the full committee and board membership). This is a purely practical limit based on the governance and decision making still required under collaboration, rather than any financial or investment management limit reached due to the combined value of funds….
>
> Relying on greater collaboration across a larger number of funds (or all funds in the SLGPS) would seem to very quickly reach practical limitations on the generation of efficiencies and may in fact slow decision making to the extent that investment opportunities are missed or governance becomes unwieldy. Scottish Water would be concerned that this option for a future structure could be advocated simply to avoid more complex changes with greater potential for more significant efficiencies. *Scottish Water*
>
> We recognise that there has been some good progress to collaborative working initiatives as referred to …with Lothian, Falkirk and Fife on investments. This approach provides opportunity where for example, a fund feels infrastructure is a viable vehicle, but either small fund size or relative large charges may not make that feasible in the current structure. Also with funds pulling resources and materials for the introduction of public service pension reform in 2015. However we also appreciate there are limitations to the scalability of this approach which could restrict the level of efficiency that could be achieved. *Police Scotland*
>
> Our experience of collaborating with other funds shows that such arrangements can take time to establish and require governance changes. The current Joint Investment Strategy Panel is in very early stages and its success in terms of delivering cost savings has not yet been proven. Further, the Joint Investment Strategy Panel arrangement is not scalable. Overall, Lothian has concerns that relying solely on greater cooperation could be sub-optimal, could adversely impact on the Fund and avoid more integrated change which is necessary to achieve optimal efficiencies. *Lothian Group*

2. *Requires internal investment management or separation of governance*

Some suggested that cooperation would not yield savings to investment costs unless internal management was used or governance was separated from administering authorities.

The chief benefits of cooperation accrue to funds with in-house management, therefore benefits of cooperation to small and medium funds would be limited:

> … We understand that at least 92% of fund costs are investment management fees. As governance costs are therefore only a fairly small proportion of total fund costs, any change to the administrative structures of the funds is likely to be missing the bigger opportunity.
>
> We understand that LPF's model of managing a significant proportion of the fund via internal investment managers has resulted in strong fund performances in conjunction with significantly lower investment management costs than externally managed LGPS funds across the country … We also understand that there is wide precedence for such an approach, including the University Superannuation Scheme in the UK and a variety of other public bodies across the world. We also understand that whilst delivering savings on cost, such in house investment teams have also delivered greater returns than external fund managers, accepting of course that such outperformance can never be guaranteed. However, if in house teams are well recruited and managed, we believe there is reason to be confident of significant bottom line improvements.
>
> The options of greater cooperation between funds or investment pooling of funds would only recognise benefits in relation to investment management costs if the resulting fund was managed by an in-house team. … most funds will simply be too small to have their own in-house investment management teams… It is important to recognise that even if another group of funds wished to adopt the in-house investment management approach, they may find their council HR processes would limit their ability to attract and retain top fund management talent….
>
> The options of greater cooperation between funds or investment pooling of funds would only recognise benefits in relation to investment management costs if the resulting fund was managed by an in-house team. Given that the LPF is the only Scottish fund with an in-house investment management team, we would conclude that options 2 and 3 would be unlikely to deliver on material overall fund management cost savings unless the LPF model of in-house investment management is used. *Edinburgh Leisure*

Governance must be separated from administering authorities

> Collaboration can bring benefits, but there are limitations when governance remains with the administrating authority. Lead funds can only advise under FCA rules and processes can be slow. *UNISON*

3. Multi-fund footprint preserved

Multi-fund employers suggested unless cooperation led to homogeneity between funds, it would not resolve their difficulties with the scheme:

> As a multi fund employer, collaboration in administration could still result in different approaches amongst funds, unless one common approach was adopted across all which also risks dilution of local expertise and best practice within each fund. *Police Scotland*

4. Consolidation has greater benefits

Some responses suggested the benefits of collaboration would not be as great as consolidation or that for smaller funds only consolidation might have greater benefits. For example:

Future development of the structure may also involve pooling or merger of funds but this should only occur where individual funds agree that this would be to the benefit of their members and employers. Smaller funds should give serious consideration to these options. *SPF*

We are aware that collaboration between Administrators currently takes place which would allow this option to be progressed. Greater efficiencies could be achieved through a single fund rather than maintaining 11. *Scottish Fire*

If Fund merger is not mandated, then Funds should be encouraged to continue their efforts in developing collaborations with other Funds. This would however mean a lack of uniformity across the Funds with collaborations all at various different levels and stages. There would also have to be an acceptance that by maintaining the 11 Funds – albeit with some collaboration - costs would most likely have to rise to allow smaller and medium sized funds to properly address their ever increasing compliance, resilience and regulatory obligations. *Falkirk Council Pension Fund*

Overall, Lothian has concerns that relying solely on greater cooperation could be sub-optimal, could adversely impact on the Fund and avoid more integrated change which is necessary to achieve optimal efficiencies. *Lothian Group*

Option 3: Pool investments between the 11 funds

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

a) Cost of investing

Original questions

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

What positive impacts did respondents see from pooling investments on the cost of investing?

Respondents cited the following positive benefits for pooling on the cost of investing:

1. Reduced investment management fees
2. Pooling could broaden investment portfolios and retain local control
3. Pooling's impact will vary by fund scale with benefits for small funds and none for large funds
4. Cost reductions from England and Wales have already been passed on so pooling will produce no additional benefits for Scotland

1. Reduced investment management fees

Some responses said combining funds, potentially under internal investment management could reduce fees:

> Pooling provides an opportunity for the SLGPS funds to achieve a greater level of assets being managed in-house, resulting in reduced investment cost. The clearest path to this would be through leveraging Lothian's internal investment team which has an investment expense ratio that is 80% lower than the overall SLGPS. Cost savings would be offset by initial set-up costs, but once achieved, the cumulative savings over the long term would be substantial (e.g. on a cumulative basis £1bn by year 10, £3.bn by year 20, £8bn by year 30

Lothian believes that, with the commonality of investment strategies, and our awareness of fees in the industry, combining investments would undoubtedly deliver significant savings in investment fees. In-house management is the clearest and most effective way for SLGPS to reduce the cost of investing. Cost savings could also be achieved from consolidation of external investment management arrangements and reduced reliance on expensive investment vehicles.

In comparison with the Universities Superannuation Scheme (USS) (£63 billion, 418,000 members, 380 employers and an in-house investment team), the SLGPS is significantly more expensive. USS investment fees are 34% lower (0.31% of investments, compared to 0.47% for the SLGPS), largely attributable to the fact that c75% of USS assets are managed internally (vs c10% for SLGPS). While we note that the USS expense ratio of 0.31% is based on independent third-party benchmarking analysis, not their accounts, we also believe it to be more rigorous than the SLGPS ratio of 0.47% given the under-reporting of SLGPS fees (as described earlier).

If SLGPS could achieve the USS expense ratio of 0.31%, fee savings could be £65 million per annum, and given the under-reporting of SLGPS fees, actual savings could be materially higher. More expensive investments are typically illiquid so savings from these allocations could take time to materialise. However, separate analysis (based on Lothian's internal team expense ratio of 0.09%) suggests that material savings of £65m per annum would be possible from in-house management of SLGPS liquid assets alone.

While evidence from England and Wales pooling suggests that set-up costs have been significant, cost savings could outweigh these but savings may take time to materialise. The compounding effect of cost savings and the incremental returns on costs saved, should significantly outweigh any initial setup costs. *Lothian Group*

With the assets pooled, there will be a reduction in the high management costs of administering all 11 funds….. Economies of scale will allow for improved purchasing power at both micro and macro level. Increase investment bargaining power at a macro level. With increased wealth of assets this would command greater leverage.

Reduce costs – administering just 3 or 4 funds, as opposed to 11, will reduce investment management functions which will reduce running costs. There are huge savings potential in pooling assets. This is borne out in the consultation paper Appendix 1 reference to the APG Report commissioned by UNISON which found that investment expenses and administration costs decline when the size of the fund increases and that larger funds consistently achieved higher investment returns. APG identified savings in investment management of £7m and that an improved investment performance could have let to £772m of additional assets for Scottish funds. *Unite*

There is potential reduction in cost through ability to negotiate better rate if funds have more money to invest. *SPDS*

A move of this type would be likely to result in lower cost investing, subject to some initial cost increases to manage a transition. It would also be likely to mean that the asset pool was of a significant enough size that more of the investment and administrative tasks could be undertaken in house. *Robertson Group*

Respondents said that savings would depend on the pooled funds investment portfolio composition and the net returns produced:

Reducing costs is important but will only deliver benefit if it improves net investment returns. *Scottish Borders Council Pension Fund*

There would be an economy of scale benefit on costs when investing but any savings would be dependent on the type of investment, as all investments have different cost levels. Reducing investment costs does not guarantee increased returns, so the effect on net-of-fees

> returns could quite possibly be minimal and out of proportion to the work and upheaval required to establish the Pools *Shetland Islands Council Pension Fund*

Other respondents said cost reductions depended on pools reaching size thresholds, such as the cost tiers that external investment managers use for fees. This may require pooling to be compulsory. For example:

> A modest [benefit]. Asset pooling should result in cost savings through the benefits of scale – managers currently offer lower fees if assets invested exceed particular thresholds. One of Falkirk's external managers, has provided an example of this whereby a global equity strategy might cost 0.54% for a £100m mandate but 0.39% for a £1b mandate. *Falkirk Council Pension Fund*

> Fees savings would only be optimised if pooling is compulsory. If individual funds retained the option whether or not to pool investments or not on an asset-by-asset basis, fee savings may not be delivered. *Lothian Group*

Some respondents said it was not clear whether pooling would offer greater savings than other options. For example:

> The academic research indicates that there should be savings in fees and access to a wider range of investments. What is not clear is if these savings could be delivered if there was better collaboration, use of national contracts and or improved contract management. *SEPA*

2. *Pooling could broaden investment portfolios and retain local control*

Some respondents mentioned additional investment opportunities and retention of local control as other benefits of pooling.

Additional investment opportunities:

> Some direct investment opportunities may be possible that would not have been considered by the Fund due to the higher initial due diligence costs and/or scale of investment required. *Orkney Islands Pension Fund*

> A wider mix of asset classes could be available for investment due to the pool size *Shetland Islands Council Pension Fund*

Retains local control:

> Investment strategy would remain under local control, which is crucial…*Shetland Islands Council Pension Fund*

> …the [administration] for all 11 funds will be retained locally with back-office and admin functions, as well as the in-house expertise, remaining *Unite*

3. *Pooling's benefits will vary by fund scale with benefits for small funds and none for large funds*

Respondents said pooling might be of most benefit to small funds as large funds already enjoy scale benefits.

Pooling might benefit small or medium funds, by lowering costs or broadening portfolios:

> Could result in some savings in the cost of investing for smaller to medium size funds but likely to be offset initially by additional set up costs. For smaller funds the potential for cost savings and the chance to invest in a broader range of asset classes. *Scottish Children's Reporter Administration* .

> Some larger Administrators may not experience cost savings or benefits but smaller ones might, therefore reducing the overall cost across the Scottish Administrators. *Scottish Fire*

Some respondents said large funds already enjoyed scale benefits, so pooling would offer no additional advantage:

> TPF already enjoys significant benefits of scale and is effective in ensuring lowest cost investment fees as demonstrated in independent assessments by Audit Scotland, therefore TPF believe further efficiencies in existing mandates unlikely through adding further scale. *Tayside Pension Fund*

> The main driver of Fund return is its strategic asset allocation rather than manager selection. Under pooling, the asset allocation decisions would remain with a local Fund. Consequently, the overall impact of pooling in terms of overall returns is likely to be limited. *Falkirk Council Pension Fund*

> At £21 billion, SPF already enjoys significant benefits of scale. It is unlikely that this would improve significantly through adding further scale. SPF typically pays the lowest fee tier available to investors or a lower negotiated rate. …It is unlikely that SPF would see any significant positive cost impacts from pooling investments. *SPF*

> The larger Administrators already benefit from the scale of their investments, so pooling funds may benefit smaller funds. *Scottish Fire*

> …there is no clear evidence of where the tipping point is to achieve economies of scale, therefore pooling does not guarantee any 'real' benefits. *NESPF*

> It should be possible for larger pools to enjoy lower costs however it is not necessarily the case that bigger funds have lower investment costs. *Orkney Islands Council Pension Fund*[24]

> It is difficult to see how there would be a net improvement in Fund performance without an assumption that bigger Funds perform better. *Comhairle nan Eilean Siar*

What negative impacts did respondents see from pooling investments on the cost of investing?

Respondents cited the following negatives for pooling on the cost of investing:

1. High set-up costs
2. Pooling in England and Wales show no benefits or must run longer
3. Cost reductions from England and Wales have already been passed on so pooling will produce no additional benefits for Scotland
4. Larger funds do not have lower costs, or produce higher returns so pooling's impact will be limited
5. Concentration of the market for investment managers
6. Reduction of investment effectiveness

[24] To see the chart supporting this response showing investment management expenses of the funds prepared by Audit Scotland, please see the earlier section "How would respondents determine if the benefits of a local connection in governance outweigh the benefits of scale?" where a chart from the same source was submitted by Tayside Pension Fund.

1. *High set-up costs*

Respondents cited set costs as being a negative impact of pooling. Some suggested costs could be greater than benefits, or that it may take overly long to recoup costs, or costs savings may come with other negatives. For example:

> Pooling of investments would require significant restructuring of LGPS investment mandates at significant cost. *CIPFA*
>
> Potential cost of pooling in setting up investment funds; large initial set up, transition and reorganisation costs. will require substantial professional advice from pension fund managers, investment consultants and actuaries. *SPDS*
>
> Investment management fee reductions /short term benefits may be delivered but these are also likely to be offset by transition and reorganization costs. *Scottish Borders Council Pension Board*
>
> The initial setting up of the pool would be a costly and time consuming project, and it could take many years to recoup the set up and reorganising costs. This is evident from the experience in England and Wales. *Shetland Islands Council Pension Fund*
>
> There are also the significant ongoing costs of the staff managing the pool to be considered. *Shetland Islands Council*
>
> Pooling therefore looks to be costly to set up and manage which could take many years to recover. Some English & Welsh Funds will not reach break-even point for at least 10 years, and others will actively be worse off as a result of pooling, due to their positive starting point *Shetland Islands Council Pension Fund*
>
> The cost of maintaining the pool would be an additional cost that would ultimately fall on the investing funds. *Dumfries and Galloway Council Pension Fund*
>
> Significant transition costs will be incurred where funds decide to move assets from their current fund manager to the pooled investment fund manager. *Highland Group*
>
> Cost savings are likely to take time to be realised and ultimately are not guaranteed. *Falkirk Council Pension Fund*

Some said any cost savings won may be outweighed by other negatives:

> Cost reduction through pooling would be a negative if it led to a restricted choice of investment options, and reduced returns or increased risk. *CI-SSSC*
>
> The Council has identified that pooling arrangement would be distracting to the purpose of the NESPF, to working constructively and effectively with us as an employer and would be time, resource intensive and costly to set up, with no guarantee of cost savings in the short to medium term if the experience of England and Wales were repeated. *Aberdeen City Council*
>
> This will take up Council officer time adding strain to the Pension service, along with additional Pool costs that will filter through to employer's contributions which will affect the Council's services. *Shetland Islands Council*
>
> There is evidence to suggest that scale in investments can bring down the cost of investing, however, there is also evidence to suggest that pooling investment can be extremely costly. *Fife Council and Fife Pension Fund*

Some respondents said that the costs of pooling could lead to higher contribution rates:

> The costs involved with pooling will hit employers contribution levels which will have knock on effects to the Council's own budgets and level of service. This is a concern given the actual situation which is happening in England and Wales. *Shetland Islands Council*

> Increased contribution rates following pooling could lead to legal challenge and dispute. *Scottish Borders Council*

2. *Pooling in England and Wales show no benefits or must run longer*

Some respondents said reforms in England and Wales had not demonstrated reduced costs from pooling, or was too early to say:

> Our understanding is that there is no evidence that costs have actually been reduced where pooling has taken place in England and Wales. We would therefore be risking a low cost well managed fund potentially pooling with funds which have higher investment and admin costs and are worse performing. *Abertay Housing Association*

> … in England & Wales…the government has advocated this approach but left it to individual funds to work out the best means to achieve it. It is really too early to say whether pooling actually works and in the short term, the effect has been to see some pools achieving what is thought (as a rule of thumb) to be the minimum size for investment scale advantages, approximately £25bn, while others are still well short of this figure. *Scottish Water*

> It is too early to assess from England and Wales pooling whether the savings will justify the disruption and bureaucracy that the pool structure brings. Proof of concept remains to be established. *Falkirk Council Pension Fund*

> While supporting Option 3, lessons must be learned from the failings in the model in England and Wales where the pooling of funds has not delivered a reduction in costs at a level thought possible. Unite recognise that the transition to a new scheme will require time and that initial set up costs will be required. However we believe in the long run this option will deliver savings to the scheme. *Unite*

> Whilst acknowledging investment pools have been formed for LGPS funds in England and Wales, we understand that it is too early yet to rely on their experience to form a view on the potential cost and benefits of doing so. *Police Scotland*

3. *Cost reductions from England and Wales have already been passed on so pooling will produce no additional benefits for Scotland*

Some respondents said cheaper external investment management fees resulting from reforms to the local government pension scheme in England and Wales had already been passed on to Scotland, leaving little additional benefit to be gained from pooling:

> The Council is unclear on what scale that would be and how it could assess what additional benefit could be achieved from lowering investment costs based on evidence of costs having been taken out of the system already through the pooling in England and Wales – e.g. passive equity fee levels. *Aberdeen City Council*

> Pooling in England and Wales would appear to have made managers more competitive. Further cost transparency initiatives should help in this direction. It could be said that Scotland is already benefiting from this without needing to pool assets. *Falkirk Council Pension Fund*

4. *Larger funds do not have lower costs, or produce higher returns so pooling's impact will be limited*

Some respondents said that there was no evidence that large funds necessarily have lower costs or perform better. For example:

> [The Mercer study] does not support the view that larger fund always have lower costs and perform better based on their snapshot analysis of the LGPS 2015 accounts. *CIPFA*

> It is difficult to quantify costs as there is no evidence to suggest that large Funds have lower costs than smaller Funds. With the combination of past efforts by Scottish Funds, and the cost transparency developments, it would seem that the SLGPS is already in a good place. *Shetland Islands Council Pension Fund*

> There is no evidence that a large Fund will save costs, and no guarantee of better investment returns. *Shetland Islands Council Pension Fund*

> There is no evidence that larger Funds necessarily achieve higher net returns and there is therefore a risk that the cost of any change will never be recouped. *Comhairle nan Eilean Siar*

5. *Concentration of the market for investment managers*

Some responses suggested pooling could lead to market concentration of external investment managers and poorer price competition:

> The drive to reduce costs may lead to a reduction in the number of fund managers willing and able to engage with the LPGS. One effect of pooling on passive investments in E&W is that fees have been reduced to the level where there are now fewer larger players left in the market. *CIPFA*

> Gains made may be eroded over time by the oligopoly power enjoyed by the few remaining big players. *Live Borders*

6. *Reduce investment effectiveness*

Some responses said large pools could restrict investment choice:

> Cost reduction through pooling would be a negative if it led to a restricted choice of investment options, and reduced returns or increased risk. *SEPA*

> Loss of opportunity to invest in smaller projects out with the pool. Pools themselves may be unable to invest in certain projects / markets due to size constraints. *Dumfries and Galloway Council Pension Fund*.

> Some very attractive investment opportunities, particularly in private markets, have limited availability. A larger pool may be unable to achieve its desired allocation and is unlikely to achieve cost savings as managers have no need to offer cost incentives where demand outstrips supply. *SPF*

> Where Funds are merged, the pooled structure might struggle to achieve an asset allocation that meets their return, risk and liquidity requirements where demand exceeds supply such as infrastructure or private debt. *Highland Group*

Under what circumstances do respondents think a fund should consider joining an asset pool?

Respondents cited the situation of the SLGPS; clearer evidence of benefits, smaller funds, best interest of members, individual fund requirements and improved net performance as different circumstances funds could considering joining a pool:

If the situation of funds in the SLGPS was worse:

> Funds in Scotland are healthy, well-managed so there seems little motivation to change so dramatically. *SPDS*

If a Fund had a high level of fund manager fees, staffing issues and a poor funding level the merits of joining a pool structure might be considered. *Shetland Islands Council Pension Fund*

If evidence of benefits became clearer:

A fund should carry out its own cost benefit analysis of the merits of joining an asset pool. Until a pool is established this is difficult as neither the costs nor the benefits are clear or certain. *SPF*

Ideally we would want to see an evidence base of investment pools of a similar scale to what we would be moving to and the level of investment returns and costs achieved. *North Ayrshire Council*

The Fund would also have to complete a full cost benefit analysis before joining an asset pool but this cannot be done until there is performance and cost data available. *Highland Group*

For smaller funds to win economies of scale:

Joining an asset pool may benefit the smaller funds through economies of scale. *SPDS*

Best interest of members or members and employers:

…if stakeholders unanimously believed that the decision to pool is in the best interests of their members to whom they have fiduciary duty to act in their best interest. *Tayside Pension Fund*

Funds need to consider what is in the best interests of their members and employers in considering whether to join an asset pool. Considerations should include: Governance of pooling versus not pooling including resourcing and alignment of interest; Investment options offered by the pool and associated costs; track record; and operational risks *Lothian Group*

If pools met the individual requirements of funds:

It would be up to each fund to determine how available asset pools meet their own individual investment requirements. Basic passive pools are more likely to meet more funds requirements, however it may not always be possible to meet specific requirements through a pooled investment vehicle. *Dumfries and Galloway Council Pension Fund*

…having recognised the governance challenges, two or more Funds felt that their investment objectives could be better achieved through a pool. *Falkirk Council Pension Fund*

Following cost benefit analysis relating to the merits of joining an asset pool and how this would fit with wider investments decisions. *East Ayrshire Council*

It would only be if the return, risk and liquidity of investment opportunities offered by the pool fit with the Fund's investment strategy that the Fund would consider joining an asset pool. There would also have to be a performance track record for the asset pools. *Highland Group*

If an asset pool is established that is invested in an asset class or classes that meet the Pension Fund's investment strategy and the fee structure is better than is currently enjoyed then it may be worth joining the pool. This is essentially the same as any other investment decision made by the Fund. Or, if the pool is able to offer an investment in an assets classes that the fund cannot access by another means. *Orkney Islands Council Pension Fund*

Improve the net performance of funds

Pooling is only justifiable where there is evidence it will lead to a net improvement in Fund performance and there will be no detriment to the Fund. Since the level of funding in each Fund varies, a mechanism would be required to ensure no individual authority was disadvantaged. *Comhairle nan Eilean Siar*

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

Respondents cited a strong business case, sustained governance failures; funds unable to meet long term liabilities or objectives; as tests that could be used to direct funds to pool.

Only on a voluntary basis:

> By taking investment decisions out of local authority pension fund control such direction would in effect mean Scottish Ministers were assuming responsibility for any negative impact arising from pooling on investment returns, funding levels or scheme participation rates. *Scottish Borders Council Pension Board*
>
> Given our reservations on pooling, we do not think there are circumstance where funds should be directed to pool. *Lothian Group*

Strong business case:

> A strong business case is required for each proposal SLGPS isn't one fund – directing funds would be done via legislation but why legislate without evidence ([England and Wales] experience) of benefits. *SPDS*
>
> strong evidence that there are current issues or under performance with the current set up which would justify the potential start up costs, local governance dilution and changes in investment strategy which would follow. The Council would be cautious of a drive to implement wholesale pooling based on the assumption that "bigger is better"; or as a route to increased infrastructure investment – fund reorganisation would need to be based on demonstrable benefits to members; not wider public policy intentions. *Renfrewshire Council*
>
> Only if the business case can be clearly established or if individual funds are failing to achieve their targets. *Scottish Children's Reporter Administration*

Sustained governance failures

> The only circumstances where this should be considered is if there was sustained evidence of governance failures at a local level... *CIPFA*

Funds unable to meet long term liabilities or objectives

> …or evidence that funds were completely unable to meet their long term liabilities on an actuarial basis. *CIPFA*
>
> if there was clear evidence that funds were unable to manage and failed to meet their investment objectives and there was potential for detrimental impact to members and employers. *Tayside Pension Fund*
>
> Manifest failure by a fund, or the Scottish LGPS funds collectively, to achieve their objectives might present a basis for directing funds to pool. *SPF*
>
> where a fund was basically failing and not achieving its aims, and required outside help. An assessment of the fund's situation would need to be conducted to see if it would be beneficial for the fund to join a pool. However Government should take great care before forcing a Fund down a particular course of action which may increase a Fund's costs in excess of the potential benefits achieved *Shetland Islands Council Pension Fund*
>
> where a Fund or Funds are demonstrably unsustainable. *Comhairle nan Eilean Siar*.

> If a Fund has poor investment performance and inadequate funding levels, there is a risk that future liabilities to pay pensions will not be fulfilled. *Highland Group*

> Funds are underperformed and pooling would rectify this. This needs to be balanced against the risk of doing so. *Fife Council and Fife Pension Fund*

b) Governance

Original questions

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

What do respondents see as the positive impacts of pooling on governance?

Some respondents said there would be no impacts. Other respondents cited the retention of existing scheme arrangements, cost reductions and improved decision making as positive impacts.

1. No impacts
2. Retains existing arrangements
3. Cost reductions
4. Improved decision making

1. No impacts

Several respondents believed there would be no positive impacts, for example:

> It is unlikely that SPF would see any significant positive governance impacts from pooling investments. *SPF*

2. Retains existing arrangements

Retaining existing SLGPS features was cited as a benefit. For example:

> Known and established local governance agreements would remain in place allowing the Pension Board arrangement to evolve and strengthen. *Fife Council and Fife Pension Fund*

> Current governance structures would remain in places avoiding costly restructuring and preserving recent changes made to enhance governance through the establishment of Boards…. Would allow funds to maintain their current asset allocation strategies in response to current funding position and risk appetite. *CIPFA*

> Pooling would not eliminate the potential for collaborative working – this could still happen at a local level and sharing of knowledge, experience and expertise across funds would no doubt be beneficial in this scenario. *Fife Council and Fife Pension Fund*

3. *Cost reductions*

Reductions in administrative and transaction costs were cited. For example:

> Benefits in sharing administration would not be precluded under this option and could still be looked at as a further development. There is no guarantee there would be a positive outcome. *Fife Council and Fife Pension Fund*

> There may be a saving in fees and transaction charges. *SEPA*

4. *Improved decision making*

Bringing more resources to bear on decision making was cited. For example:

> Pooling would have a significant impact on governance. It has the potential to improve investment decision making by allocating greater and specialised resource, including internal resource. *Lothian Group*

> the removal of investment manager decisions from local decision-makers would improve matters by focusing their attentions on the more important issue of investment strategy: however this brings into question why significant work is needed to address the lower risk issue of manager selection. *Shetland Islands Council Pension Fund*

> There is the prospect of more skilful investment decision making (i.e. better manager selection and oversight), although this depends on Scottish Pools being able to resource up successfully – not a given - both in terms of attracting the appropriate quality of staff / pool board members whilst maintaining costs at an acceptable level. *Falkirk Council Pension Fund*

> However the admin for all 11 funds will be retained locally with back-office and admin functions, as well as the in-house expertise, remaining…The retention of local oversight and strategy decisions will bring governance closer to members. It is important that decisions on pensions have some degree of 'subsidiarity' where the two-way flow of decisions and information can allow for member input. This will also increase transparency as decisions about the funds can be cascaded more easily to those that the decisions will affect most, its members. *Unite*

> Pooling could bring the greater professionalism into the investment governance of the SLGPS, including internal investment management resource. *Lothian Group*

What do respondents see as negative impacts of pooling on governance?

Respondents cited the following negative impacts of pooling on governance:

1. Set-up issues
2. Extra costs, layers of governance and bureaucracy
3. Cannibalises administering authority staff
4. Unclear responsibilities or conflicts
5. Capture by internal managers
6. Dilution of stakeholder influence

1. *Set-up issues*

The processes required to establish pools were cited as negatives:

> Staff would be required to run the new pools at potentially significant cost if staffing arrangements and grades sit out with LGPS pay structures. *CIPFA*
>
> Creation would incur cost on start-up, would require re-consideration of local pooling/ underwriting of small, affiliated bodies. *SPDS*
>
> Diverting resource to establish and maintain the pools is likely to be a significant distraction from the ongoing business of managing the funds. It adds a level of cost which will reduce net returns to the funds. *SEPA*
>
> The work and time require to setup the initial pool would require additional resources of governance. Any structure that adds additional management layers such as a pool will increase the governance complexity and time allocated to the governance function. *Shetland Islands Council Pension Fund*
>
> There has been no consistency around the way in which pools have been set up in England and Wales. They differ in size from £15bn to £40bn and there are at least 5 different operating models. All of which serves to illustrate the rather experimental nature of the initiative. It is not clear how long it will take to transition all Fund assets to the pools – possibly 10 years – and the process has already been running for a number of years. *Falkirk Council Pension Fund*
>
> There would be difficulty in funds agreeing an approach for a SLGPS pool. Funds may consider the investment options offered by the pool as too restrictive and, and as a result, asset pooling, and cost savings, would not be optimised. *Lothian Group*

2. *Extra costs, layers of governance and bureaucracy*

Costs, additional governance and a loss of decision making flexibility were cited:

> Whilst pooling would be expected to reduce investment costs through scale, there is as yet still a lack of clarity in the decision making process between funds and the investments they own within a pool. The extra layer of governance means that additional costs are likely to be introduced into the Scheme through this route, which would need to be outweighed by greater investment returns or efficiencies in investment management fees. *Scottish Water*
>
> Where pools oversee external investment managers, this represents an additional layer of governance between the fund and the manager. It is likely to reduce transparency and complicate governance….Loss of flexibility which could have negative impact in meeting objectives and ultimately in costing more to employers / and member benefits. *Tayside Pension Fund*
>
> .. Careful consideration would need to be given to the most appropriate legal structure(s). In England and Wales, structures and governance vary significantly between the pools and lessons should be drawn from their experience. *Lothian Group*
>
> Increased governance arrangements would be required, so more costs and resources. *Scottish Fire*
>
> there is no clear distinction between strategic investment decisions and investment implementation as evidenced by pools in England and Wales adopting different approaches. *Lothian Group*

3. *Cannibalises administering authority staff*

Respondents said pools could lead key staff to leave to run the pools. For example:

> This creation of new pool investment management roles has seen some funds losing their most experienced and valued employees, as pools are prepared to out-pay the local authorities to secure the necessary skills and knowledge. Consequently, funds themselves may be struggling to maintain even their previous levels of governance and informed accountability within pension committees. *Scottish Water*

> …may reduce opportunities for elected members to access financial advice and reduce expertise at a local level. *Scottish Borders Council*

4. *Unclear responsibilities or conflicts*

Pooling could make responsibility for decision-making unclear, strategy options could become insufficiently granular and offer greater potential for conflicts. For example:

> There may be difficulties between pools and funds as to who has responsibility for aspects of asset allocation. Nominally this is the role of the Fund but how far down the asset chain does this go (e.g. would a Fund be able to make a specific allocation to a UK Equity Value mandate or would it be confined to allocating to UK equity or only Listed Equities as a whole?). The more granular the asset allocation by the Fund the less scope for scale benefits (and savings) that the pool will have. There may be difficulties between pools and funds as to who has responsibility for ESG matters. Different Funds in the same pool may have differing investment principles. How can this be efficiently undertaken by the pools. *Falkirk Council Pension Fund*

> There could also be a lack of clarity of responsibility for responsible investment and stewardship matters i.e. who votes and engages on shareholdings. *Lothian Group*

> Tangible evidence is scarce however anecdotal evidence of pooling so far seems to indicate that the process has been problematic with concerns over loss of local accountability and governance resulting in disagreement e.g. the London CIV. *CIPFA*

New regulatory requirements could lead to conflicts:

> As Pools are managing monies on behalf of Funds this brings them under the purview of the Financial Conduct Authority, whereas Funds are subject to the statutory rules. This is likely to create tensions. *Falkirk Council Pension Fund*

5. *Capture by internal managers*

Some response said pooling could lead to capture by internal managers, for example:

> Where pools manage investments internally, we believe that the funds may become captive – i.e. it would be difficult to replace the internal management team if they underperformed. *Tayside Pension Fund*

6. *Dilution of stakeholder influence*

Pooling could reduce the influence of pension committees and stakeholders or require new measures to prevent dilution of influence:

> …reduces the Pension Committee's control and governance over the fund and its investment performance. *Shetland Islands Council Pension Fund*

> Pooling investments would remove employers further from the Pension Fund's investments and the management and oversight of those investments. This is in complete contrast to the recent legislation that gave employers more responsibility by including them on the Pension Boards. *Shetland Islands Council*

In pursuit of good governance, there would be a requirement to build in enhancements that compensated adequately for any perceived dilution of local accountability/influence. *East Lothian Council*

Pooling would result in a dilution of local expertise and knowledge potentially increasing risk to the smaller councils where staff often performs a wider role with respect to the financial management of the authority. *CIPFA*

The recent legislation which improved governance through the set-up of the Pension Board that included employer and Union representation, would see their role significantly reduced regarding the governance of the actual investments and the fund managers. *Shetland Islands Council*

c) Operating risks

Original questions

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

What impacts did respondents see on operating risks from pooling investments?

Responses included comment on externally and internally managed pools; oversight; set-up and maintenance costs; investment risks and retention of existing scheme arrangements.

1. *Externally managed pools*

Respondents were divided on whether pools managed externally would increase or decrease risks. Some respondents suggested this represented the status quo, so risks would not increase; others saying there would new risks. For example:

Pools oversee external investment managers, pooling is unlikely to have any impact on operating risks, as day-to day investing is carried out by the managers. *SPF*

There is likely to be little impact on operating risks arising from pooling. Day to day investment would continue to be carried out by line managers. *Scottish Borders Council Pension Fund*

For the Orkney Islands Council Pension Fund, it is unlikely that there would be any significant change. All investment decisions are currently delegated to Fund Managers who operate within investment guidelines. Pooled funds would operate in much the same way. *Orkney Islands Council Pension Fund*

Potentially increased operating risks as there would be the existing operating risks of the managers, but then a new layer of risks associated with management of the pool. *Tayside Pension Fund*

Potentially increased risks as the pool would have to be managed / monitored, whether internally or externally managed. *Scottish Fire*

2. *Internally managed pools*

Respondents said internally managed pools would require increased resources to meet the operating standards of externally managed funds.

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

> If the pools are managing funds internally, staff would need to have the same level of skills and expertise to manage risks as external managers or there would be a risk to investment performance. Risk that the pool's internal investment team does not have access to the same level of research and analytical resources as external fund managers. *Highland Group*

3. *Oversight*

Respondents were divided on whether the oversight arrangements would increase or decrease operating risks.

Some cited improved resourcing, reduced key person risk and oversight of manager selection as reducing risks. For example:

> Having a qualified and experienced Pool Board should lead to better oversight of the manager selection process. *Falkirk Council Pension Fund*

> Linked to recruitment of skilled, dedicated staff, better oversight of investment managers. May reduce risks in manager selection process and key person risk. *Scottish Children's Reporter Administration*

> Some might argue that larger funds have an ability to absorb extra administration. *East Lothian Council*

> Having sufficient qualified and experienced resource at the pool should lead to better manager selection. This should reduce key person risk at the Funds. Better oversight of investment managers with selection and monitoring being transferred to an entity with appropriate knowledge and understanding. *Lothian Group*

> Funds could devote more time to non-investment operational risks *Lothian Group*

Others cited unclear responsibilities and accountability as increasing operating risks:

> The changing governance responsibilities of the Pension Board and the Pension Fund Committee would create uncertainty of roles with the pool which could have possible operational issues increasing risk. *Shetland Islands Council*

> Risk of loss of local accountability/influence. *East Lothian Council*

> Fund Committees would be distanced from their underlying investments due to the extra layer of governance represented by the Pool. *Falkirk Council Pension Fund*

> It is unclear how the pools would tender for or select fund managers, and what level of choice of fund managers per asset class the Pension Committee would have. *Shetland Islands Council Pension Fund*

> Potential complications for annual accounts data requirements. *Highland Group*

4. *Set up issues*

Resourcing pools and transactions to establish portfolios were cited as raising operating risks. For example:

> Loss of experienced individuals to investment pools *Fife Council and Fife Pension Fund*
>
> The timing of the financial transitions required to establish pools may be problematic if disinvestments are executed at a time when markets are volatile. This will introduce risk and unnecessary cost. *CIPFA*
>
> Cost on start-up, would require re-consideration of local pooling/ underwriting of small, affiliated bodies. *SPDS*
>
> Diverting resource to establish and maintain the pools is likely to increase operational risks. *SPF*
>
> The establishing and maintenance of pools (including their legal structure, staffing, interaction with Funds, etc) would be a substantial undertaking and a major distraction from the daily business of running the Funds. *Falkirk Council Pension Fund*
>
> Duplication of effort both within the pools and in Local Authorities increasing cost overall *Fife Council and Fife Pension Fund*
>
> Funds' resource could be transferred to the pool, therefore exacerbating their operational risks. The time spent in England and Wales to establish the pools has been significant and this could increase operational risks for the SLGPS. *Lothian Group*

5. Investment risks

Respondents disagreed on whether pools would raise or reduce investment risks.

Some cited the benefits of diversification:

> Possibly allow smaller funds to access a wider range of asset classes. *Dumfries and Galloway Council Pension Fund*
>
> Funds can be grouped into distinct projects i.e. infrastructure, housing, building schools/hospitals etc. spreading any risk. *Unite*

Some suggested pooled funds could be less diverse due to larger individual investments or concentration of investment managers or excess scale

> Far greater risk associated with larger scale investments (types/locations) in pursuit of growth. *NESPF*
>
> …there could be a negative impact due to the potentially limited availability of asset classes: the Funds would be restricted to choose from what the Pool had on offer. *Shetland Islands Council Pension Fund*
>
> Pooling will in all likelihood lessen the number of fund managers in the LGPS concentrating investments with fewer firms, reducing diversification and arguably increasing risk.There is also the possibility that pools may grow to a size where there is a negative impact on performance. *Dumfries and Galloway Council Pension Fund*

Some cited the risks of perverse incentives:

> Increasing cost may perversely cause pools to invest in higher risk, higher yield assets to recover the ground lost through timing losses and to recover reorg/ transition costs. *CIPFA*

> The need for the fund to recoup the cost of change and the potential length of time this will take and the impact on the performance of the funds *Fife Council and Fife Pension Fund*.

6. Retention of existing SLGPS arrangements

Respondents disagreed whether pooling would allow them to retain local investment strategies and thus raise or lower operating risks. For example:

> Funds would retain their own investment strategies relevant to their local fund requirements, funding levels, risk appetite Local expertise would be retained e.g. staff with knowledge and expertise in pensions, investment, and an understanding of pension benefits this is an asset within the Local Authorities. This would potentially be lost in a merger arrangement. *Fife Council and Fife Pension Fund*

> Bespoke employer strategies would be far harder to deliver in a pooled environment. *NESPF*

d) Infrastructure

Original questions

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

What impact did respondents see from pooling on funds' ability to invest in infrastructure?

Respondents covered the following areas in their comments on pooling's impact on infrastructure investment:

1. Little impact as funds can already invest
2. Smaller and medium funds may benefit
3. Economies of scale and diversification
4. Standalone pools
5. Mismatch against fund investment strategies

1. Little impact as funds can already invest

Some respondents suggested pooling would have little impact as large and medium sized funds already invest in infrastructure or because investment decisions were made solely within the purview of each fund's investment strategy. For example:

> Due to the current scale of the SPF it already invests in infrastructure and there are already vehicles in place to pool investments for certain infrastructure projects. *North Ayrshire Council*

> Of the large Scottish Funds: SPF has made investments of over £1 billion to date in infrastructure and will continue to make new investments; Lothian has an established infrastructure programme. Amongst the medium-sized funds: per the Scheme Advisory Board Annual Report for 2016/2017, Fife and Falkirk are shown as having infrastructure investments So, large and medium sized funds are already able to invest in infrastructure. *SPF*

> There will be little impact on the ability to invest in infrastructure. Decisions to invest in infrastructure are based upon as assessment of the benefits and risks associated with such investments. These decisions sit within a Fund's overall asset allocation strategy and cannot be viewed in isolation. *Scottish Borders Council Pension Board*

Others suggested pooling could allow larger scale investment but these may not suit Scottish funds so the impact would be limited:

> Pooling may allow Funds to invest in larger scale infrastructure assets, but these may not necessarily be suitable for Scottish Funds in terms of their risk and return characteristics and diversification needs. *Falkirk Council Pension Fund*

Others suggested pools took time to set up so it may take some time before pooling had an impact on infrastructure investment

> Pools in England and Wales will only be turning their attention to alternative assets (incl. infrastructure) once more mainstream assets have been transitioned. Therefore, the benefits of scale investing in infrastructure may take some to materialise. *Falkirk Council Pension Fund*

2. *Smaller and medium funds may benefit*

Some respondents suggested infrastructure pooling would primarily be of benefits to small funds. For example:

> Little impact for those who currently invest in infrastructure though may allow smaller Administrators to begin these investments or invest more. *Scottish Fire*

> Although it might facilitate infrastructure investment by funds who currently don't, but the potential increase in allocation to this asset class would not materially change the total investment in infrastructure / be minimal. *Abertay University*

> The smaller funds (<£1 billion) do not appear to have made any infrastructure investments. It may be that they lack the resource to do so, though with consultant support it is not clear why this would be the case. Pooling investments might facilitate infrastructure investment by these funds, but their total assets are £2.3 billion of the £43 billion total scheme assets, so this would not materially change the total investment in infrastructure. *SPF*

3. *Economies of scale and diversification*

Some respondents cited scale and diversification benefits of pooling for infrastructure investments. For example:

> Potential for greater diversification opportunities through economy of scale. *NESPF*

> Pooling investments would give an additional size to the overall pool to allow it to consider offering an investment vehicle in infrastructure to the funds. Any fund considering an investment in infrastructure would still have to compare it to other investments and decide if it fits into their particular investment strategy. *Shetland Islands Council Pension Fund*

> Creating larger investment pools may make it easier for funds to access infrastructure investments, where funds acting alone may not have the expertise or scale. *Scottish Water*

> Pooling should enable more funds to invest in infrastructure. While Lothian itself has an established infrastructure programme, pooling could give access to wider infrastructure opportunities, with more favourable terms. *Lothian Group*

> Pooled funds [may have] the critical mass to absorb very high startup costs for infrastructure investments. *Orkney Islands Council Pension Fund*

4. Standalone pools

Some respondents said pooling for infrastructure investment represented the status quo. For example:

> This is the model for all of SPF's existing infrastructure investments, including the Pensions Infrastructure Platform (PIP), which was created by a group of UK pension funds, including SPF, to invest in UK infrastructure. *SPF*

> Infrastructure investment typically does operate on a pooled basis – with investors pooling resources, usually through a limited partnership structure to increase their buying power and share risk. *Tayside Pension Fund*

They were divided on whether there was merit in creating additional standalone infrastructure investment pools that funds could participate in voluntarily:

> It is not necessary to create pools to facilitate investment in infrastructure. Infrastructure investments are generally accessed through a limited partnership structure to increase their buying power and share risk. As mentioned previously, there are ongoing collaborations between Lothian Pension Fund and other funds to invest in infrastructure. *Highland Group*

> If there are already vehicles in place to pool investments for infrastructure projects then it would likely be a costly and time consuming exercise to go through without necessarily any additional benefit to what is there currently. *North Ayrshire Council*

> Setting up a pool for investments is a very expensive proposition to try and achieve an increase in infrastructure investment. This could be achieved more easily through the collaboration approach or simply investing in an existing investment pool or insurance contract. *Shetland Islands Council Pension Fund*

> The consultation paper acknowledges that: "In the short-term, pooling would generate large initial transitional and set up costs, potentially including the requirement to seek FCA authorisation for the new asset pools." Pooling the funds simply to achieve more investment in infrastructure, which is not a primary pension fund objective, would be a perverse decision in this context. *SPF*

> Some administrators are already involved in such investments as the Pensions Infrastructure Platform, so may have some merit. *Scottish Fire*

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

> [But the] positive impacts of identified by SFT are not related to the objectives of the LGPS and its funds…It would not be necessary to pool funds in their entirety to facilitate investment in infrastructure. The creation of a pooled investment vehicle in which funds could invest would achieve this if the vehicle was sufficiently attractive on a risk/return assessment…[Negatives of this would be] large set-up costs [and] FCA authorization requirements. *Tayside Pension Fund*

5. Mismatch against fund investment strategies

Some responses said infrastructure pooling may not align with fund investment strategies

> A pool approach to infrastructure may not align with the investment objectives of a local Fund (e.g. a local Fund may wish to target infrastructure with higher return characteristic than the pool or vice versa). *Falkirk Council Pension Fund*

> There is a potential risk that enforcement of initiatives, such as investing in infrastructure, endangers the funds' fiduciary duty to act in the best interests of the members and employers. It needs to be recognised that political desire for infrastructure is not necessarily in the best interests of members and employers. Conflicts of interest need to be avoided, particularly for local investments. *Lothian Group*

e) Respondents additional comments about Option 3 and respondents explanations for their preference for Option 3

This section summarises respondents additional comments on Option 3 and also includes relevant comments from Question 5a 'Which option does your organisation prefer'.[25]

Arguments in favour of Option 3: Pooling

Arguments supporting pooling mentioned the need for pools to be structured in particular ways if the option was to be of benefit:

1. Should include multiple pools and be voluntary
2. Should exclude funds that already have sufficient scale
3. Needs to include internal investment management
4. Needs to resolve governance issues created by internal management

1. Should include multiple pools

There should be more than one pool:

> Unite would support Option 3 which will pool investments between the 11 funds creating a fund with assets of around £42 billion. The scheme would operate by pooling the assets into 3 or 4 separate funds, thereby spreading the risk. Each of the 11 funds will remain open for basic local administration purposes. It is only the assets that are pooled. Unite does not see a benefit in merging the liabilities within each fund. These should remain with the local council and could be reduced through any cost savings obtained. *Unite*

> We support any efforts to pool investments to achieve cost savings and benefit from economies of scale however [we] believe that retaining eleven different funds with one common investment pool could give rise to further challenges in governance and implementation of funds' investment strategies. Generally we understand the LGPS funds in Scotland to be in a better funding position than those in England and Wales so the appetite amongst funds to align in investment pooling may differ. This could release the opportunity for savings and benefits to be realised. For example, some funds may be moving more towards a low risk investment strategy if they have a strong funding position, which does not align to the objective of the investment pool. It would therefore be important for the structure of the investment pool to allow for the required individual funds investment strategies. *Police Scotland*

2. Should be voluntary and exclude funds that already have sufficient scale

Pooling may not be necessary for large funds:

> Also we recognise that Strathclyde Pension Fund is already of a similar size to the pooled funds set up in England and Wales so arguably the benefits of scale for the largest LGPS fund in Scotland are already in place. *Police Scotland*

> Participation should be voluntary and based on risk / return of each investment. *Scottish Fire*

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

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[25] Comments that covered investment costs, governance, operating risks and infrastructure can be seen earlier in this section.

3. *Needs to include internal investment management*

Some responses said pooling would require funds to be internally managed to yield cost benefits. For example

> While supporting Option 3, lessons must be learned from the failings in the model in England and Wales where the pooling of funds has not delivered a reduction in costs at a level thought possible. There are also issues around a lack of oversight and control in governance in some funds and we need to ensure we do not emulate these concerns. Therefore, Option 3 should include an in-house investment team to over-see investment decisions and scrutinise running costs bringing increased transparency and oversight. We must be mindful however that we don't then create a bureaucratic burden that costs as much to administer than is saved by altering the scheme. *Unite*

> The options of greater cooperation between funds or investment pooling of funds would only recognise benefits in relation to investment management costs if the resulting fund was managed by an in-house team. Given that the LPF is the only Scottish fund with an in-house investment management team, we would conclude that options 2 and 3 would be unlikely to deliver on material overall fund management cost savings unless the LPF model of in-house investment management is used….most funds will simply be too small to have their own in-house investment management teams, hence our support of the merger option. It is important to recognise that even if another group of funds wished to adopt the in-house investment management approach, they may find their council HR processes would limit their ability to attract and retain top fund management talent…*Edinburgh Leisure*

4. *Needs to resolve governance issues created by internal management*

Internal management used by pools would require new governance structures. For example:

> We understand that there are varying governance models in place in England and Wales between pools and lessons should be drawn from their experience. Where pooling could bring improved investment decision making with professional specialised resource, including internal investment management, it adds an additional layer of governance between the fund and the investment manager and has the potential to complicate the strategic investment decisions with their implementation and reduce transparency and diluting the ability to influence at individual fund level, unless an effective governance structure is in place. *Police Scotland*

Arguments against Option 3: Pooling

Respondents made the following arguments against pooling:

1. Evidence from England and Wales
2. The SLGPS is a success story
3. Public policy towards infrastructure is not a justification for pooling
4. Cost savings could be won by other means
5. Concentration or risk
6. Will not resolve issues with cessation

1. *Evidence from England and Wales*

Some respondents cited the England and Wales experience as an argument against pooling:

> The consultation…in Scotland is being undertaken against the background of reform in England and Wales where there is as yet no strong evidence of the effect that pooling has actually had. *CIPFA*

It is much too early to judge whether the pooling initiatives of England and Wales have been successful in meeting their objectives, however what is clearly apparent that is that this has been a costly and time consuming exercise with no standardised approach or clearly planned strategy. The payback period for costs incurred is likely to span many years and it is also likely to be some time until the pools settle fully into their new structures as all pools differ in set up, structure and objectives… pooling of England and Wales has stripped resources from administering authorities who still require skills and resources, therefore potentially increasing risk of detrimental impact in the management of the funds. *Tayside Pension Fund*

It is concerning that the evidence base used for pooling in England and Wales is so patchy, old and unrelated to UK LGPS funds. Any move to restructure the current LGPS in Scotland must be based on sound empirical evidence and must deliver tangible improvement for both large and smaller funds when compared to the current structure. *CIPFA*

Long term sustainability of the SLPGS is not about investment costs alone. The SLGPS make up is somewhat different to the E&W LGPS. The SLPGS is made up of only 11 Funds with the largest Fund by far making up approx. 50% therefore following E&W down the pooling route is not necessarily the best option for Scottish Funds i.e. potential cost savings if any would not be to such a scale and therefore would not justify such a radical shift, when all evidence to date shows the current Scottish Model is working very successfully. *NESPF*

England and Wales have reorganised the LGPS into eight large pools, which has been under construction for a few years, and still has no known outcome on costs, investment returns or even actual agreements on some of the pool's structures. This does not set a good example to follow, especially when the Scottish LGPS position is well funded. *Shetland Islands Council Pension Fund*

As the main employer in the Fund, pooling looks as if it will increase costs, as has been witnessed in England and Wales. This will only increase employer's contributions unless investment returns are higher and there is no evidence for this. This could continue to be the case for many years with a long term cumulative effect on the Council's budget and ability to maintain services. Given the current good position of the fund with stable employer contributions the option of moving to a pooled structure does not make sense. *Shetland Islands Council*

Pooling has its advantages in terms of probable cost savings, added resilience, the expertise of the Pool Board and the potential for scale investment in infrastructure. However, the model is untested, clouds governance responsibilities and creates a new tier of bureaucracy. It is a live and long term experiment, which, anecdotally, appears to be throwing up practical difficulties between the Funds and the Pools. It would be disruptive and could adversely impact Fund members, pensioners and other stakeholders. On balance, Funds and their stakeholders should not be exposed to this risk. *Falkirk Council Pension Fund*

The England and Wales model of pooling is generally not delivering the scale of investment or the promised criteria. Some pools are doing better than others when they have adopted good governance models. The Scottish Futures Trust (SFT) is developing a different approach to pooling in Scotland. However, this is at an early stage and focused more on property than infrastructure. Issues of governance, guarantees and trust, remain to be addressed. *UNISON*

2. The SLGPS is a success story

Some respondents said 'if it isn't broken, don't fix it'; the SLGPS is success story and so the status quo should be preferred.

While the Council agrees continuous improvement is desirable, current performance suggests there is no immediate requirement to address performance or governance issues, therefore any step to direct Funds to pool should be taken extremely seriously and be based on sustained evidence of governance or performance failures. Strathclyde Pension Fund has recently confirmed there is no need to increase employer contributions following the recent

triennial revaluation as the Fund is 105% funded. In addition, the Fund has secured numerous national awards relating to scheme management and overall performance. *Renfrewshire Council*

3. *Public policy towards infrastructure is not a justification for pooling*

Responses said public policy on infrastructure should not inform a move to pooling in Scotland. For example:

> The Council would be cautious of a drive to implement wholesale pooling based on the assumption that "bigger is better"; or as a route to increased infrastructure investment – fund reorganisation would need to be based on demonstrable benefits to members; not wider public policy intentions. *Renfrewshire Council*

> Infrastructure investment is not the primary objective of the LGPS, and thus fiduciary duty must be considered if considering pooling the funds simply to achieve more infrastructure investment in infrastructure. *Tayside Pension Fund*

4. *Cost savings could be won by other means*

Some responses said cost savings could be better sought by other means. For example:

> Cost savings could instead be made through development of internal resources leading to greater in-house investment management and reduction in external fund manager fees to support sustainability in the long term *NESPF*

5. *Concentration or risk*

Pooling could lead to concentration of investment and economic risks. For example:

> There could be a potential risk of a single point of failure and there could be a risk of significant job losses with a consequential impact on Scotland's economy. Finally, it is not clear what impact this would have on pension benefits. *COSLA*

> There are 11 Scottish LGPS Funds all investing specifically for their Pension Funds using many different fund managers in different assets, which creates a very low risk diversified structure. A Pool would reduce the diversification of fund managers and asset classes, significantly increasing investment risk through concentration of investment. *Shetland Islands Council Pension Fund*

6. *Will not resolve issues with cessation*

Pooling would not address the issues admitted bodies face with cessations:

> A single pool would double the asset size to about £42Bn over the largest Fund which has assets in excess of £20Bn. At this size it would be of a similar size to 3 of the English pools and larger than the 3 others so it would not be excessively large but would have sufficient scale. Fund assets and liabilities would still be allocated in the same way to ensure specific employer responsibility for liabilities. A move of this type would be likely to result in lower cost investing, subject to some initial cost increases to manage a transition. It would also be likely to mean that the asset pool was of a significant enough size that more of the investment and administrative tasks could be undertaken in house. From a governance perspective each Pension Committee would retain responsibility for asset allocation and managing the legislative structure however day to day investment management would be delegated to the pool. As has been shown in England and Wales this approach is very achievable and it's hard to deny the value so this would seem to be a minimum required step. However other than the potential for reduced cost of pension provision such an approach is unlikely to meet the administrative demands of charitable employers participating in the Funds...*Robertson Group*

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

The fourth option presented to respondents was for funds in the SLGPS to merge, with assets, liabilities and administrative functions being managed by one or more larger funds

a) Cost of investing

Original questions

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

What positive impacts do respondents see from mergers on the cost of investing?

Some respondents suggested there would be no benefits from mergers. Others cited buying power with external managers; savings from internal management; and other scale benefits as having a positive impact on investment costs from mergers.

1. Cost savings from buying power with external managers

Some responses said mergers would benefit small funds by increasing their buying power but larger funds may already enjoy scale benefits. Cost benefits may come at intervals as mandates are re-let or be restricted to particular assets classes

Cost savings or extensions of opportunities for small and medium sized funds

> A positive impact. The Falkirk Fund has assets of £2.3bn. A reduction in fees of 5bps (5 basis points = 0.05%) translates into a saving of around £1.2m per annum. Savings would not be realisable from every asset classes (some costs are unavoidable being tied into longer term illiquid assets). *Falkirk Council Pension Fund*
>
> It is unlikely that SPF would see any significant positive cost impacts [from merger]. *SPF*
>
> Some larger Administrators will already achieve significant economies of scale and pay minimum fees however these could be passed on to smaller funds by combining all together. *Scottish Fire*
>
> Some direct investment opportunities may be possible that would not have been considered by the individual funds due to the higher initial due diligence costs or scale of investment required. *Orkney Islands Council Pension Fund*

Cost savings would filter through as mandates are re-let:

Where savings are achievable, this would take time to gain traction and most likely occur as mandates were re-let. The bottom line is that a merged Fund could expect to have increased buying power to secure lower fees. *SEPA*

Savings would not be achieved immediately or even realised from every asset class (as fees, such as illiquid infrastructure assets, may be fixed for the long term). Nonetheless, savings could potentially be realised each time a mandate was being let or re-let. *Falkirk Council Pension Fund*

Savings may be limited to particular asset classes:

There may be cost savings with investing larger amounts but it depends on which asset classes, for example passive equities have seen fees slashed in recent years so any cost savings would be minimal. Some asset classes have an oversupply of investment so would be unwilling to cut fees. *Shetland Islands Council Pension Fund*

2. Cost savings and improved net returns from internal management

The benefits of internal management were cited as the primary benefit of merger by some respondents.

UNISON's own research reinforces the benefits of scale. A study we commissioned from the Dutch pensions group, APG (The Netherlands probably has the best pension system in the world), showed that a single fund in Scotland would have delivered an additional £830m p.a. Even accepting the limitations of any historical look back, this is a huge difference and would be a much higher saving at today's prices.

In the current austerity driven Local Government setting, savings can also reduce pressure on public service spending, freeing up resources for jobs, services and pay. Every basis point (0.01%) shaved off costs equates to £3.5m. *UNISON*

Merger would undoubtedly deliver significant savings in investment fees. In-house management is the clearest and most effective way for SLGPS to reduce the cost of investing. Cost savings could also be achieved from consolidation of external investment management arrangements and reduced reliance on expensive investment vehicles. In-house management is best practice for large funds with sufficient scale and governance to implement (e.g. Lothian) and the clearest route to generating cost savings for SLGPS. This is evidenced worldwide, where large funds manage more of their assets in-house:

- In Canada, the top 10 largest funds manage an average of 80% of assets in- house. PwC's Global Pension Funds best practices report states "… the practice is considered a key factor in cost savings for Canadian pension funds and is credited as a main reason for their success."

- In the US, funds with US$50bn+ manage an average of 45% assets in-house; CalPERS – the largest US state fund – manages 75% assets in-house;

- The UK's largest fund, USS, manages 75% assets in-house;

- Sweden's largest fund, Alecta, manages close to 100% assets in-house; -

- Australia's largest fund, AustralianSuper, plans to increase its in-house assets from 23% to 50% over the next few years. Other Australian funds have also been in-sourcing asset management as they become large enough to hire professional investors, thereby saving on fees that would be paid externally.

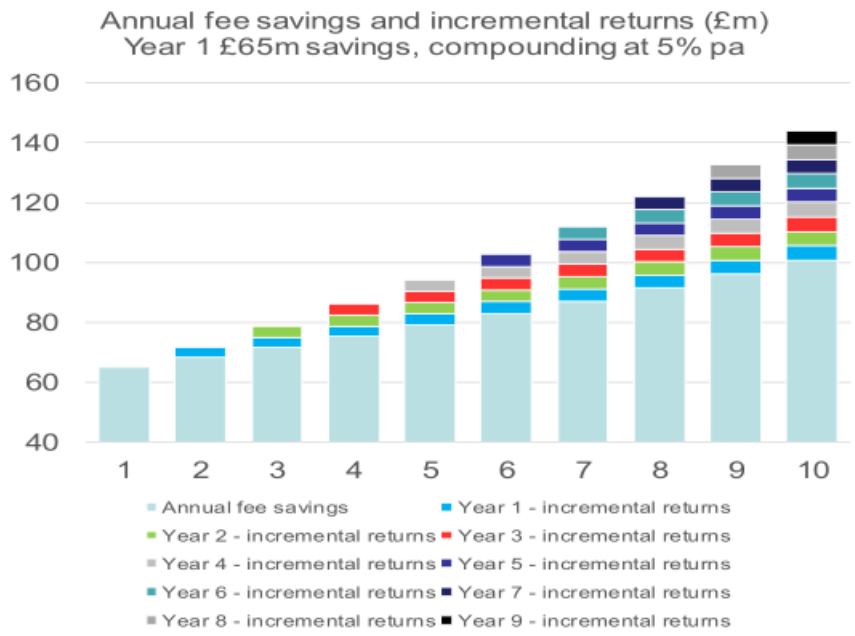
Fund merger, alongside appropriately revised governance structures, provides the most direct route to increased in-house management and significant cost savings for SLGPS.

In comparison with the Universities Superannuation Scheme (USS) (£63 billion, 418,000 members, 380 employers and an in-house investment team), the SLGPS is significantly more expensive. USS investment fees are 34% lower (0.31% of investments, compared to 0.47% for the SLGPS), largely attributable to the fact that c75% of USS assets are managed internally (vs c10% for SLGPS). While we note that the USS expense ratio of 0.31% is based on independent third-party benchmarking analysis, not their accounts, we also believe it to be more rigorous than the SLGPS ratio of 0.47% given the under-reporting of SLGPS fees (as described earlier).

If SLGPS could achieve the USS expense ratio of 0.31%, fee savings could be £65 million per annum, and given the under-reporting of SLGPS fees, actual savings could be materially higher. More expensive investments are typically illiquid so savings from these allocations could take time to materialise. However, separate analysis (based on Lothian's internal team expense ratio of 0.09%) suggests that material savings of £65m per annum would be possible from in-house management of SLGPS liquid assets alone.

… the most significant impact in terms of cost savings will arise from a greater proportion of assets being managed in-house. Further, the benefits from initial savings will compound over time. For example, £65m in fee savings from in-house management provides a benefit in "Year 1" when it is realised, but it is also a benefit in year 2, where it would have also been paid, and every year after. Further, the £65m saved in year 1, generates incremental returns in year 2, year 3, year 4 etc into the future. The example of fee savings and incremental returns, year on year, is shown in the chart below.

The chart shows that £65m in savings in "Year 1", becomes c£100m of savings in year 10 (as underlying assets have grown). Further additional benefits from incremental returns come to £40m in year 10. Cumulatively, by Year 10, SLGPS has benefited by £1bn in total (from initial savings of £65m in Year 1). The long-term benefit from in-house fee savings will therefore far outweigh any initial transaction/merger costs. *Lothian Group*



3. *Other scale benefits*

Respondents highlighted other scale benefits from mergers, including clarity, expertise, shared practices and lower administrative costs.

A merged structure would bring greater clarity and certainty to decision making (compared with collaboration) as there would be one agreed Fund strategy and one set of investment principles to be adhered to. With collaboration, differences could still exist around investment objectives, ESG beliefs making governance more cumbersome. Any fee savings would help with fund solvency and feed into a stronger funding base or lower employer rates. (Although, in this regard, a 'normalisation' of interest rates is far more likely to have a marked impact on solvency). Better investment governance through the larger entity being able to afford and attract more specialist expertise. More engaged in ESG matters / better stewardship of Fund in terms of its role as a responsible investor. Lower administration costs, reduced duplication. *SEPA*

Better control of costs through an enlarged structure being able to devote greater resource to this complex area. *Falkirk Council Pension Fund*

Reduced tendering costs and investment manager fees across the 11 funds rather than taking individual interests into account. *Scottish Fire*

There would be an increased set of investment opportunities and greater influence over the terms of investment. Merger(s) should also reduce pensions administration costs… All the funds use the same pensions administration system which should facilitate merger. *Lothian Group*

There are examples of good practice across funds that potentially could be better developed in a single fund. *East Lothian Council*

Research carried out by Deloitte in 2011 suggested that costs per member in Scotland compared favourably with LGPS funds in England and Wales and that a single operating model and common administration system may have a greater benefit than formal administration mergers. However, research by APG concluded that administration costs decline with larger funds and certainly this seems to be the model being employed across UK defined contribution businesses. Future cost savings need to be considered against any transition costs. *Robertson Group*

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

Costs and their impact on net returns; absence of scale benefits; investment inefficiencies and job losses were cited as being a negative impact on the cost of investing from mergers.

1. *Recouping set-up and ongoing costs and impact on net returns*

Mergers would generate significant set-up and ongoing costs and have an unclear impact on the net returns of funds. For example:

Merger would require significant restructuring of LGPS investment mandates at significant cost. *CIPFA*

There is evidence to suggest that scale in investments can bring down the cost of investing, however, there is also evidence to suggest that merging pension funds can be extremely costly. *Fife Council and Fife Pension Fund*

Cost is only part of the investment picture as it is the investment performance return less costs that is important. Reducing investment costs does not guarantee increased returns. *Shetland Islands Council Pension Fund*

There may be savings on investment manager's fees with larger portfolio sums but as for pooling there will be significant restructuring costs incurred along the way with no guarantee that improved investment performance will be achieved….The costs of restructuring would be

significant and could be drag on fund performance for many years. *Orkney Islands Council Pension Fund*

The effect of any merger on Fund diversification is not known. There is a risk that investment in assets with higher risk profiles over many years may be required to compensate for the costs of merger. *CIPFA*

The Tayside Pension Fund currently has a low contribution rate and high funding level compared with most other Scottish LGPS funds. Any move which merged the fund with other funds is likely to result in worse performance and as a result an increased employer contribution rate. A 1% increase in employer contribution rates would lead to increased costs of £10k, which represents a 0.14% increase in rents for our tenants. *Abertay Housing Association*

There are likely to be transitioning costs in re-aligning investment strategies albeit strategies could be harmonised over time as mandates came up for renewal. *Falkirk Council Pension Fund*

Significant costs of transitioning assets to a merged fund and consultant fees (investment advisors, actuaries. *Highland Group*

The increased responsibility on internal monitoring of investment management is likely to drive the need for more skilled staff, which in turn will increase costs as they are likely to be higher paid than the existing staff. *SEPA*

A merger would involve large set up costs plus disinvestment and reinvestment costs of funds reorganising to go into a merged fund. These costs are unknown but will be a drag on all of the funds positions for a long time, due to the great upheaval of arranging such a merger. *Shetland Islands Council Pension Fund*

The timing of the merger may force asset sales at a time of volatility resulting in significant investment losses. *Highland Group*

The establishment of a merged entity may need mutual agreement between various parties and this could take some time to establish. The costs however, should be relatively small in relation to the potential cost savings. *Lothian Group*

Fund employers would not be able to accommodate change to contribution rates, furthermore, and which would be as a result as a drop in funding level would not be in the best interest of the scheme membership. The potential impact of "what could happen" is demonstrated below following 2014 valuation: *Tayside Pension Fund*

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

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

2. *May not deliver additional scale benefits*

Some responses said mergers may not deliver scale benefits, because larger funds do not always have lower costs; funds may already enjoy scale benefits; or improvements in fees following reforms in England and Wales:

Evidence of scale benefits:

> The study undertaken by [Mercer] does not support the view that larger fund always have lower costs and perform better based on their snapshot analysis of the LGPS 2015 accounts. *Scottish Borders Council Pension Fund*

> There is no clear evidence of where the tipping point is to achieve economies of scale, therefore merging does not guarantee any 'real' benefits. *NESPF*

> It is difficult to quantify cost savings as there is no evidence to suggest that large funds have lower costs than smaller Funds. *Shetland Islands Council Pension Fund*

> Larger funds may be able to access cheaper fees due to scale. This may provide smaller funds, who manage a minority of LGPS assets, with some benefits but these gains are likely to be marginal at best. Audit Scotland analysis of fees does not show a significantly different level of investment costs across the varying LGPS funds in Scotland. *Scottish Borders Council Pension Board*

> The consultation document notes significant cost savings as a potential advantage of this option. There is however as yet little UK and clearly no Scottish evidence to support this assertion. *CIPFA*

Scale benefits already gained:

> TPF already enjoys significant benefits of scale and is effective in ensuring lowest cost investment fees as demonstrated in independent assessments by Audit Scotland, therefore TPF believe further efficiencies in existing mandates unlikely through adding further scale. *Tayside Pension Fund*

> There is no clear evidence of where the tipping point is to achieve economies of scale, therefore merging does not guarantee any 'real' benefits. *NESPF*

> At £21 billion, SPF already enjoys significant benefits of scale. It is unlikely that this would improve significantly through adding further scale. SPF typically pays the lowest fee tier available to investors or a lower negotiated rate. *SPF*

England and Wales:

> NESPF have already benefitted from reduced investment management fees (through economies of scale) as a direct result of the pooling across the English & Welsh LGPS Funds. It is unlikely in our opinion that any further significant cost savings could be achieved in the long term to justify the complexity and immediate costs of pooling the Scottish Funds. *NESPF*

> Both investment advisors and investment managers have noted that the effects of pooling in England and Wales are already providing benefits for the Scottish LGPS through lower fees while to date the costs of restructuring have been avoided

3. Investment efficiency

Respondents said mergers could create funding issues; mismatches between investments and other parameters; bureaucracy; and concentration and diseconomies:

Funding issues:

It is not clear what effect this option would have on funding levels, which could potentially change for individual employers under a fully merged structure. Merger would require a new asset allocation strategy for the new funds linked to funding levels and a new combined actuarial valuation. *CIPFA*

Concern at what might be the impacts upon actuarial valuation? *East Lothian Council*

Uncertainty of the impact that merger will have on funding levels and could adversely impact funds being merged and result in increased employer contribution rates. *Highland Group*

Members were concerned about the risks associated with merger that the surplus built up by the Fund could be converted to a deficit if merged with under-financed schemes. *Highland Group*

Mismatch between funding, pension liabilities or employer policies:

Need separation of individual council/employer portfolios because of different arrangements in Council/employer policies. *East Lothian Council*

The effect on funds contribution is not known. It should be noted however that some of the smaller funds have the lowest contribution rates at present indicating a high degree of efficiency in terms of cost and investment returns. The funds in rural areas also have the some of the highest longevity for fund members. *CIPFA*

Loss of local accountability – ability to determine asset allocation, investment strategy at a local level. *NESPF*

It would need to be very clear that the ultimate goals and benefits for the funds' beneficiaries would justify taking on the very significant challenge, cost and potential distraction of aligning very different funding positions, membership profiles and investment strategies of each particular fund. *Children's Hearings Scotland*

Bureaucracy:

Believe merger would add an additional layer of bureaucracy and cost and loss in ability to make the optimal investment decisions for the benefit of the funds members and employers. Fear could increase contribution costs to employers at a time when Abertay has second lowest rate in the SLGPS at 17%. *Abertay University*

Concentration and diseconomies:

The effect of any merger on fund diversification is not known. *CIPFA*

Cost reduction through [merger] would be a negative if it led to a restricted choice of investment options, and reduced returns or increased risk. *SPF*

Some very attractive investment opportunities, particularly in private markets, have limited availability. A larger pool may be unable to achieve its desired allocation and is unlikely to achieve cost savings as managers have no need to offer cost incentives where demand outstrips supply. *SPF*

Funds may become too big to be managed effectively *Scottish Children's Reporter Administration* .

4. Job losses/loss of capability at administering authorities

Job losses or loss of capability at administering authorities were cited as disadvantages:

> There will be an impact on fund staff. If administration of benefits are streamlined, there will be a reduction in staff employed. *SEPA*

> Loss of local knowledge and experience. *Dumfries and Galloway Council Pension Fund*.

> If increased contribution costs could not be absorbed by employers facing increases, this could lead to job losses in these areas. Dundee could be more significantly impacted by this as unemployment in the area tends to be higher than in other parts of Scotland, and as part of the Tayside Pension Fund only paying 17%, an increase of 2 or 3 percentage points could be problematic. As stated earlier there could be a mechanism for redistributing funding from "winners" to compensate those who lose out. CI/SSSC would be concerned about how this could be extended to admitted bodies. *CI-SSSC*

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

Respondents suggested it should be voluntary for all funds, would require legislation, required evidence, required a method to resolve funding differences and required appropriate governance arrangements. One response provided a full set of criteria.

Two or more funds wish to merge

> Clearly, this would need to be given mutual consideration by at least 2 funds. Each would need to carry out its own cost benefit analysis that demonstrates that such a change delivers better outcomes for its fund members than the existing structure. *SEPA*

> …if there are demonstrable, evidence based benefits in doing so – voluntary basis. *Argyll and Bute Council*

Would require legislation

> Where there was likely to be benefits to the stakeholders of the merging Funds….However, in order to provide certainty and permanency of the arrangement, any merger should be set out in statute and not just the result of a local agreement between Funds. *Falkirk Council Pension Fund*

If it were in the best interests of members

> This should only be considered where it is in considered by the pension fund committee and Board to be in the best interests of the fund members. Consultation with local authority employers will be required under the regulations. *Scottish Borders Council Pension Board*

If there were evidence

> Ideally we would want to see an evidence base of merged funds of a similar scale to what we would be moving to and the level of investment returns and costs achieved. *North Ayrshire Council*

> …if its analysis proved to be a better outcome for that fund and its members. It is difficult to envisage such a situation given the known costs and delays in the short term, and the unknown (and possibly unavailable) cost savings in the longer term *Shetland Islands Council Pension Fund*

> If mutually beneficial to all the funds merging, following an extensive cost and benefit analysis. *Highland Group*

Requires a method to resolve funding differences:

where there is evidence it will lead to a net improvement in Fund performance and there will be no detriment to the Fund. Since the level of funding in each Fund varies, a mechanism would be required to ensure no individual authority was disadvantaged. *Comhairle nan Eilean Siar*

Requires appropriate governance arrangements to be found:

A merger should only proceed if it was mutually beneficial to all funds and subject to appropriate governance arrangements. *East Ayrshire Council*

An outline business case was presented:

Lothian would consider merging if it was accompanied by:

- An effective, resourced governance structure with engaged employers and members, with wider involvement of stakeholders (including representatives from councils and other employers which are not currently administering authorities). This would be distinct from the current administering authority model
- Best practices for all funds, including scale facilitation of in-house investment and full fee transparency
- Delegation of implementation of investment strategy in a manner similar to that used by LPF to capture the 'governance premium'
- The funding positions of individual employers are protected (i.e. there are no cross subsidies)
- Service delivery to members and employers retains a 'local' connection.

The long-term sustainable benefits more than outweigh limited initial outlays. Benefits include:

- Clear governance to reinforce SLGPS duties to members and employers and minimise conflicts of interest
- Economies of scale on investments and otherwise, with reduced duplication and fewer advisers
- Consistency of service (e.g. funding, data, administration) particularly for the benefit of employers in multiple funds
- Less governance resource across the SLGPS as a whole
- Opportunity to resource adequately and better control operational risks
- Potential to involve professional skills to enhance governance and decision making.
- Therefore, Lothian's preferred option would be to work with like-minded partners on a voluntary basis to develop a mutually beneficial merger solution. *Lothian Group*

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

Responses included that mergers should be voluntary only, for governance failures, inability to meet future liabilities, for failing to meet objectives, for the best outcomes of members and employers or at the determination of the Scottish Government following the outcome of this review:

Only voluntary:

[Only on voluntary basis]… merging should not be prescriptive. *NESPF*

Governance failures:

Significant evidence of governance failures…*CIPFA*

Inability to meet future liabilities after deficit recovery period:

…there is a clear inability to meet future liabilities following a deficit recovery period agreed with the fund actuary. *Scottish Borders Council Pension Board*

Significant governance failures, investment under performance and/or inadequate funding levels which means that future liabilities to pay pensions will not be fulfilled. *Highland Group*

if funds were unable to meet their liabilities going forward, and there is clear evidence of the savings and/or enhanced returns that could be made. *Dumfries and Galloway Council Pension Fund*

…would effectively be a statutory intervention by Scottish Ministers and should only be considered as a last resort. *Scottish Borders Council*

Inability to meet investment objectives to the detriment of members of members:

Manifest failure by a fund, or the Scottish LGPS funds collectively, to achieve their objectives might present a basis for directing funds to merge. *SPF*

only be considered if a fund was failing and required help. An assessment of the fund's situation would need to be conducted to see if it would be beneficial for the fund to merge. *Shetland Islands Council Pension Fund*

If there is evidence that the funds are failing to achieve their objectives which can be attributed to poor investment returns and high fees and there is a firm belief that a merger of funds will bring about an improvement in performance. *Orkney Islands Council Pension Fund*

…where a Fund or Funds are demonstrably unsustainable. *Comhairle nan Eilean Siar*

Where funds were not performing. *East Ayrshire Council*

If it would be the best outcomes for members and employers:

Directing funds to merge would be appropriate if merger is the structure that delivers the best outcome for local government stakeholders (i.e. scheme members and pensioners and employers). That said, merger may not be the optimum solution for all the existing funds. *Falkirk Council Pension Fund*

Directing funds to merge would be appropriate if merging funds is shown deliver the best outcome for members and employers. *Lothian Group*

As a determination by the Scottish Government following the outcome of a review:

There needs to be appropriate periodic scrutiny of the structure of SLGPS to assess the effectiveness of any changes resulting from this review, and ensure lessons are learned. We have concerns that without such oversight, lessons will not be learned, inefficiencies will continue which could leading to further SLGPS structure reviews in the future. The Pension Board of Lothian Pension Fund feel that given the radical changes that will be needed in order to allow such mergers to take place within a reasonable time period, that it would be prudent and necessary for the Scottish Government specify the number of merged funds and expected timescales for funds to work together to deliver an effective model in order to make such merged funds into a viable reality. *Lothian Group*

b) Governance

Original questions

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

What positive impacts do respondents see on governance from mergers?

Responses on the positive impacts on governance from mergers covered scale and governance effectiveness; and how the merger model chosen would affect governance.

1. Scale and governance effectiveness

Responses said the positive impacts of mergers may be for small funds not large; come from addressing weaknesses in the scheme currently; come from streamlining and costs; and come from better access to expertise.

No positives for larger funds:

> Can't see any identifiable benefit from [an East Ayrshire Council] perspective in relation to economies of scale currently being enjoyed from SPF. Smaller funds and their associated employers may benefit. *East Ayrshire Council*

Would address current weaknesses in the governance of the SLGPS, provide greater consistency:

> There would be a significant impact on governance. Merger provides an opportunity to address the inherent weaknesses in the SLGPS's current governance…Merger(s) would also bring consistency in a number of different areas including funding, actuarial valuations and pensions administration, including member service and communications. This would be helpful for employers which have members in more than one fund. *Lothian Group*

> The benefits of having a single scheme which is not accountable to a local authority and can operate in an as outlined in question 1b above should provide greater flexibility and consistency in staff terms and conditions, and therefore provide the opportunity to attract a much higher calibre of staff. Currently also there is a lot of local autonomy and national guidance can tend to be ignored in certain areas. A single scheme would make it much more likely that changes/ improvements to the Scheme could be more consistently applied. *Robertson Group*

Reduce required governance resources required and streamline processes:

> A merged model would require less governance resource than individual governance models, but this is only truly a positive if the merged model is more effective. *SPF*

> Could be savings from back office functions. *CIPFA*

> Potential for streamlining of governance and reduction in duplication. *Dumfries and Galloway Council Pension Fund*

A merged model with one governance structure would be cheaper to administer. *Scottish Borders Council Pension Fund*

Compared to collaboration and pooling, a merged structure would bring greater clarity and certainty of decision making as there would be a single Fund strategy and single set of investment principles. With pooling, there will clearly be tensions between Pools and Boards. Even with collaboration, differences could still exist between Funds around investment objectives and beliefs, making governance cumbersome and decision making less effective. *Falkirk Council Pension Fund*

Less reliance on advisers. *Lothian Group*

More effective due to greater expertise:

Arguably better chance for Committees and Boards to be 'staffed' by members with appropriate skill set. This is only truly a positive if the merged model is more effective. *SEPA*

Saving on time and any costs relating to the governance of the fund at local level due to the decrease or ceasing of this function. This would only be a positive if the fund was ultimately in a better funding position with lower contribution rates and/or greater investment returns. *Shetland Islands Council Pension Fund*

Effective, resourced governance structure with engaged employers and members, with wider involvement of stakeholders (including representatives from councils and other employers which are not currently administering authorities). This would be distinct from the current administering authority model to reinforce SLGPS duties to members and employers as distinct from council responsibilities *Lothian Group*

Consolidation would allow for much more specialist staff and teams of staff to be developed who were much more familiar in dealing with key issues in a consistent way. We would even hope that perhaps there would be a specialist department to deal with admission bodies/ charities which could be more engaged with the sector and its needs as well as being party to solutions which could be applied on a more consistent basis….There is the potential to better integrate best practice and provide greater consistency across the Scheme with less room for decisions based upon local interest to be taken. In addition with greater employer consolidation there will undoubtedly be increased demand for larger employers to have all benefits consolidated in a single fund rather than across multiple schemes. *Robertson Group*

2. *More effective governance would depend on the merger model chosen*

Respondents said for mergers to have a positive impact on governance, they would require new governance models and evaluation of the desired scale.

Requires new governance models such as joint boards or a pensions authority, or separation of governance from administration:

Decisions would have to be made around the governance arrangements for the merged structure. In order to deliver democratic accountability and provide adequate stakeholder representation in line with previous SPPA guidance, a Joint Board solution or the creation of a bespoke Pensions Authority could viable models. This would especially be the case with a bespoke Pensions Authority, which would enable Committee representation to be drawn from the widest range of participating employers. A bespoke Pensions Authority would have a degree of autonomy from any single Council and would have scope to set its own policies as service needs dictated. An existing example of this is South Yorkshire Pensions Authority which was created out of a merger of Metropolitan County Council Funds in 1988. *Falkirk Council Pension Fund*

However, it should be noted that merger would have to overcome a number of challenges, many of which are associated with the administrative scale and need for effective governance

and engagement of all stakeholders, including employers and members. Such engagement would include representatives from councils and other employers that do not currently administer the funds, disrupting the existing model where local councils take on the role of scheme managers. *Scottish Water*

Which Council or Joint Body would be designated the Administering Authority of the merged Funds? To what degree would the old funds have representation in the new Fund? For example, if Falkirk, Fife and Lothian merged, with Lothian as the Administering Body, would Falkirk, Stirling, or Fife Councils be represented on the Pensions Committee? If so, how would West, East and Midlothian Councils be represented? *SEPA*

Initially, governance would have to be reviewed / maintained to ensure that arrangements were in place during a period of significant and complex change. Following this period, governance would depend on the terms of the merger and legislative requirements in place. *Scottish Fire*

More employer/stakeholders to be accommodated (n.b. albeit the Strathclyde Fund appears to cope ok with this challenge). *Falkirk Council Pension Fund*

Requires evaluation of what scale is desirable:

Consideration would also have to be given to the extent of merger (i.e. 1, 2, 3 or more "superfunds"). On balance, one Fund feels like an over concentration of risk. One Fund would also mean incorporating the Strathclyde Pension Fund into a larger Fund when it contends that it already has sufficient scale to operate successfully. A three Fund structure would enable stakeholders to enjoy the benefits of increased scale; still allow a degree of geographical connection to be maintained and avoid an over concentration of operating risk in one Fund. Limiting the amalgamation of funds to 3 or 4 of the existing funds would also be more manageable (and less risky) than trying to amalgamate 11 funds in one fell swoop *Falkirk Council Pension Fund*

What negatives impacts do respondents see on governance from mergers?

Responses said the negative impacts of mergers on governance would come from reduced local involvement, the costs of new arrangements; and concentration and accountability risks.

1. *Reduced local involvement*

Mergers would reduce the involvement of existing stakeholders:

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

It would have a significant adverse impact on local governance for those councils who currently operate a fund. *Scottish Borders Council Pension Fund*

This would likely impact on the local connection. This is very important as NAC currently receives a very professional and responsive service from SPF. *North Ayrshire Council*

Would depend on the scale of merger with larger scale mergers reducing local involvement in fund governance. *Scottish Children's Reporter Administration*

The role of the Pension Board with employer and Union representation which was set up a few years ago to improve governance would disappear. This local governance model which allowed the employers and employees to be involved and assist with the operation of the scheme would be lost with no known future model of governance. This would take

governance away from representatives of the people the fund is actually meant to be for. *Shetland Islands Council*

The Funds assess contribution and investment strategies using a risk management framework which is appropriate to their local employers, and is therefore subject to local scrutiny and accountability: this would be lost under a merged arrangement. *Shetland Islands Council Pension Fund*

The move to formal restructure would sever links to local decision making with regard to investment strategy and asset allocation removing a key role for elected members in the governance of pension. *CIPFA*

This would effectively remove a local service from local control. *Scottish Borders Council Pension Fund*

We also see issues with merging all 11 schemes into one large pension scheme, not only through an increase in risk but also with issues of accountability and transparency. It would appear that decisions will be made far from the funds members, by a select group of fund managers with little opportunity to influence that group. *Unite*

2. *Costs in establishing and maintaining new governance arrangements*

Mergers would require costly new governance arrangements. For example:

New governance arrangements would be required and this would incur additional costs to transition to the new arrangements. *CIPFA*

It will however require appropriately qualified and remunerated staff to administer and there is likely to be significant upward pay drift as such roles do not sit neatly within local authority pay structures. The cost savings are unlikely to be cheaper for the Council who will retain the same governance overheads as at present. *Scottish Borders Council*

3. *Concentrate administration among fewer individuals*

Mergers would concentrate responsibilities among fewer individuals. For example:

A merged model would increase the reliance on a smaller number of individuals and professional advisors. If things go wrong, they could go wrong with a far bigger impact across Scotland. *SEPA*

Increased reliance on fewer individuals looking after the interests of a much greater number of stakeholders could stretch oversight resources. *Scottish Children's Reporter Administration*

The merged fund would be accountable to more masters so may not truly be accountable to anyone. *Orkney Islands Council Pension Fund*

Merger may increase the risk of central government interference and/or the risk that the fund may not be accountable to the stakeholders. Appropriate governance would need to be put in place to guard against these risks *Lothian Group*

c) *Operating risks*

Original questions

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

What positive impacts on operating risks do respondents see from mergers?

Respondents saw positive impacts on operating risks from the scheme as a whole having better access to skilled resources than small and medium funds receive currently and access to deeper set specialist risk management resources.

1. *Access to better resources than small and medium funds enjoy*

Additional resources would help smaller and medium sized manage operating risks better:

> It should reduce some operating risks. With larger entity, there would be the opportunity to build a best in class resource covering the wide variety of specialisms demanded by the statutory and regulatory environment e.g. investment, administration, risk management, accounting, funding, legal, governance, communications, tax, data security, data quality, compliance. Many of these areas have their own underlying specialisms making it a challenge for small and medium sized funds to cover all the bases. *SEPA*
>
> Could reduce some of the operating risks faced by smaller Funds *Scottish Children's Reporter Administration*
>
> …it would facilitate improved service and better operational risk management including key person risks, at a time when the Scheme is facing increased scrutiny from The Pensions Regulator and other stakeholders. *Lothian Group*
>
> Reduced key man risk in particular for smaller SLGPS Funds *NESPF*.

2. *Better resources for risk management for all funds*

Merged funds could employ specialist risk managers rather than relying on external advisers. For example:

> Greater concentration of specialist, skilled roles could lead to better control and management of risks *Scottish Children's Reporter Administration*
>
> Merged funds may have more resources to effectively analyse risks and with larger structures could have in place better segregation of duties and invest in better research and risk management strategies. *Orkney Islands Council Pension Fund*
>
> The larger merged structure would have more staff and resources to rely on, with more advanced risk analysis, to help control the greater mix and size of investments in monitoring operational risk. *Shetland Islands Council Pension Fund*
>
> Arguably better outcomes for members and employers. Reduced risk of non-compliance. *Falkirk Council Pension Fund*

What negative impacts on operating risks do respondents see from mergers?

Respondents saw negative impacts on operating risks from concentration risks; merger execution risk; member servicing risks; job losses or reduced resource for councils; and disagreements on funding and costs.

1. *Concentration risks*

Merged funds would concentrate risks. For example:

> Although there has been analysis of potential savings there has not been analysis of the impact of potential failure on the collective membership and employers due to the decisions of a reduced number of individuals. Abertay University do not consider size as a guarantee of success, and the impact of failure would be catastrophic for the country. *Abertay University*
>
> Economies of scale would mean greater risk, with much bigger investment decisions requiring increasingly complex governance and higher scrutiny levels. *NESPF*
>
> In some instances merger can be beneficial – i.e. if the merged entity was more likely to achieve the objectives than either/any of the separate entities individually. However, for investors diversification is the primary risk mitigation. Merging investments is certain to involve a concentration of risk. A full merger of Scottish funds might have slightly increased probability of success. But size is no guarantee of success, and the impact of failure would be very significant. *SPF*
>
> One disadvantage of fewer larger funds may be an inability or unwillingness to access investment opportunities which would be of interest to smaller funds or pools. *CIPFA*
>
> The investment strategy of the merged fund is likely to be less diverse than all the individual strategies of the component individual funds. This increases the risk of concentration, and the subsequent impact of any poor performance. *Dumfries and Galloway Council Pension Fund*
>
> if there are a couple of larger funds set up for the SLGPS and these perform poorly with the risk of not meeting future liabilities, how will this be addressed? The current structure spreads this risk and action could be taken to address any smaller fund underperforming relatively quickly. *Highland Group*

2. *Execution risks*

Mergers face execution risks. For example:

> The merger of funds has a significant level of risk with could have severe consequences for the future of the SLGPS funds.…The proposed merger will create uncertainty which will lead to staff turnover, loss of expert knowledge and poor performance. *Highland Group Highland Group*
>
> With clear governance and appropriate resourcing and management, merger(s) should reduce operating risks. However, change brings uncertainty for the people involved in administering the funds and there are likely to be greater short-term operational risks while the merger is implemented. This would need to be managed.…Uncertainty over the future structure for the SLGPS and the perception of an adverse impact on staff, increases operational risks. We would suggest that decisions are made and changes implemented as quickly as possible, with appropriate engagement and communication, in order to minimise operational risks and any impact on services. *Lothian Group*
>
> Complexity – time, resources and getting the right expertise to see any benefit in the long term would be extremely challenging. Such a radical change in structure and way of operating poses an extremely high operating risk in the pursuit of unknown cost savings. *NESPF*
>
> The Council is concerned that this distracts the LGPS from attending to the task set for them and this results in expensive and time consuming implementation arrangements without a

clear understanding of the evidence that shows the benefits that will arise from this. *Aberdeen City Council*

The changes required to implement the new structure will be onerous, and from the outset there will be increased operational risk during the changes and with the initial operation of a new larger structure. *Shetland Islands Council*

Difficulty in selecting host authority – associated costs/challenges and risks of redesigning scheme infrastructure to support. *NESPF*

3. Administration and member servicing risks

Mergers may lead to lead to administrative failures and risks to current servicing levels. For example:

…transition may unsettle the membership encouraging transfers out of the fund and discourage new entrants. *CIPFA*

Scheme members could feel more remote from decision making, but do they care that much? *SEPA*

Members could be suspicious around motives for fund mergers – wary of it being a first step in a 'cash and grab' (so a robust and transparent governance system would be crucial). *Falkirk Council Pension Fund*

Strong possibility that larger Funds would struggle administratively, thereby failing to meet statutory functions as well as suffer from lack of local knowledge should merged Fund(s) be centralised. NESPF has invested considerable time and resources (by setting up a dedicated employer relationship team) developing relationships with our employers and the results of this hard work can be seen through the high quality data we receive monthly, strong administrative performance, an ongoing understanding of individual funding/covenant issues, training provision etc…. Potential loss of local Pension Fund Offices would mean members would no longer have option to meet/discuss pensions issues in person – growth in digital communication means the importance of face to face communication can often be underestimated. *NESPF*

Recent examples of merger in other services at national level have proved to be controversial and problematic with a lack of clarity regarding the realisation of the original objectives. *Scottish Borders Council Pension Fund*

4. Job losses or reduced resource for councils

Mergers would lead to job losses and reduce the resources available to councils:

TUPE transfer would apply to staff [that] spend a significant element of their time on pensions matters. There are potential redundancy costs to be met by pension funds….Appropriate expertise will be lost from individual councils with a knock on effect on the wider financial expertise available to the council with a potentially detrimental impact. *CIPFA*

There will be an impact on staff morale across Scotland. *SEPA*

Key personnel with wider management role may be lost to smaller councils. *Scottish Borders Council*

5. Funding, cost differentials and disagreements

Mergers could lead to disagreements on funding and cost sharing:

Unclear effect of merger on individual funding levels although we would anticipate that individual employers would be protected/ring fenced. *East Lothian Council*

Increased costs following merger could lead to dispute and potentially legal challenge by councils. *Scottish Borders Council*

Merger will have an impact on funding levels and could result in increased employer contribution rates. Local employers will have less representation and input to this process of setting employer rates and some local employers could face financial difficulties. *Highland Group*

d) Infrastructure

Original questions

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

What impact did respondents think mergers would have on infrastructure investments?

Responses included that the impact of mergers on infrastructure would be: a greater appetite for infrastructure investments; unclear or have no benefits; potential diseconomies; and political risks.

1. Merged funds may have a greater appetite for infrastructure investments

Larger funds may have a greater ability to invest and thus a greater appetite for infrastructure:

Merger could create a large investment vehicle with the capability of funding infrastructure project and savings through economies of scale. *Fife Council and Fife Pension Fund*

Greater opportunity through the scale of the merged funds, however, as stated previously, the SPF already invests in infrastructure projects and vehicles are already in place to pool funds for investment. *North Ayrshire Council*

...larger funds could access greater investment opportunities, and with appropriate resourcing, there should be an enhanced ability to invest in infrastructure. There would be greater negotiating power on fees and other governance rights. *Lothian Group*

Merged funds [may have] the critical mass to absorb very high start-up costs for infrastructure investments. *Orkney Islands Council Pension Fund*

The merger of some funds or all of the Scottish LGPS could offer a direct infrastructure vehicle which was not available to some of the Scottish LGPS. *Shetland Islands Council Pension Fund*

2. Unclear benefits

As funds already invest in infrastructure a merger may not increase total investment while larger scale infrastructure investments may not be a good fit with the funds' investment strategy:

> A merger would enable the enlarged funds to access larger scale infrastructure projects, although a) such large scale projects may not necessarily be appropriate for the Funds to invest in (in terms of risk, return and price) and b) Falkirk has been successful in making investments of around £100m through collaboration with Lothian. In short, merging the funds to achieve more investment in infrastructure (which is not a fund objective), is not a sufficient basis alone to merge. *Falkirk Council Pension Fund*

> Mergers between funds may make infrastructure investments more accessible to smaller funds but is unlikely to have much impact on the larger funds that already have infrastructure investments. If the Scottish Government had available suitable infrastructure investment opportunities through a pooled vehicle in which the Scottish LGPS funds could invest then merger of Pension Funds would not be necessary to achieve more infrastructure investment. *Orkney Islands Council Pension Fund*

> The merged fund would make the final investment decision which may not necessarily meet the objectives of the individual funds. *Dumfries and Galloway Council Pension Fund*

3. *Diseconomies, difficulty in fulfilling asset allocation and concentration risks*

Merged funds may be subject to diseconomies in investing and may concentrate risks:

> Larger funds may have a greater allocation to infrastructure which will be harder and take longer to achieve depending on the opportunities available. *Highland Group*

> Larger individual investments could represent a greater concentration of risk. *SPF*

> NESPF already has 10% allocation to infrastructure. Possible economies of scale may open up further investment opportunities but conversely may also close down other smaller opportunities leading Funds to invest in more riskier/less familiar opportunities. Either way need to be 'good' investments for the Fund (fiduciary duty would be first consideration) and there would likely need to be a wider supporting strategy in place (like in the Australian model). *NESPF*

4. *Conflict with fiduciary duties, risk of political interference*

Public policy goals for infrastructure investment may conflict with fiduciary duties while a reduced number of merged funds may be more vulnerable to political interference:

> Ultimately the long term objective of the Fund is to achieve a rate of return on investments to allow the Fund to meet the liabilities of members. An overriding focus on infrastructure is limiting, risky and could go against the Funds ultimate fiduciary duty to employers and members. *NESPF*

> As noted above, there is a potential risk that enforcement of initiatives, such as investing in infrastructure, endangers the funds' fiduciary duty to act in the best interests of the members and employers. It needs to be recognised that political desire for infrastructure investment is not necessarily in the best interests of members and employers. Governance of merged fund(s) needs to enforce this and should avoid conflicts of interest, particularly in relation to 'local' investments. *Lothian Group*

> A full merger of Scottish funds could increase investment in infrastructure, but this would depend on the investment strategy of the merged fund and those managing it. However, merging the funds simply to achieve more investment in infrastructure, which is not a primary pension fund objective, would be a perverse decision. *SPF*

e) Respondents additional comments about Option 4 and respondents explanations for their preference for Option 4

This section summarises respondents additional comments on Option 4 and also includes relevant comments from Question 5a 'Which option does your organisation prefer'.

Arguments in favour of Option 4: Merger

Respondents presented the following additional arguments in favour of Option 4, merger:[26]

1. Funds that wish to merge
2. How mergers should be implemented
3. Considerations for the structures of merged bodies
4. SLGPS should merge into two or three funds
5. SLGPS should merge into a single fund

1. Funds that wish to merge

Two funds said they wished to merge:

> As a medium sized Fund, Falkirk considers that the interests of its members and employers are likely to be best served by merging with another Fund. As the Falkirk Fund already has strong ties with the Lothian Fund (including collaborative infrastructure and private debt investments and investment manager monitoring), that would be Falkirk's choice of partner Fund. *Falkirk Council Pension Fund*
>
> Lothian's preferred option would be to work with like-minded partners on a voluntary basis to develop a mutually beneficial merger solution. *Lothian Group*

2. How mergers should be implemented

Responses examined on what basis funds could consider merging and consideration for implementing change.

The basis for funds to consider merging:

> We would support a recommendation to take forward Option 4 to merge into one fund as the preferred solution on the basis that a full business case, risk assessment and due diligence exercise is carried out to assess the required approach, timescales and costs of implementation accepting that the longer term benefits will outweigh the set up costs. *Police Scotland*
>
> Modelling of this option should include impact on the affordability of the LGPS in the medium and long term. This option requires a lot more detailed consideration of the technical aspects than the others. Consideration would need to be given to the funding levels of the schemes, the actuarial basis on which this is calculated, their demographic profiles, and other factors. *Scottish Children's Reporter Administration*
>
> a full merger would be, prima facie, our preferred option… [h]owever, there are two significant caveats 1. That cost is not the prime driver. During the consultation launch meeting in June, I was concerned that almost every contribution referred to the costs of running the 11 funds, which is only part of the picture. Any merger must be based on an assessment of net bottom line impact on the fund. If changes to create a merged body result in lower administration

[26] Respondents summarised some arguments in favour of merger made earlier, including: strong governance; strong investment decision making; cost savings; mitigation of key person risks and operational resilience; wider representation for employers; simplified administration; and national consistency of service to members and employers

costs, but also lower fund values (due for instance to higher investment management costs or poorer investment performance), then this would clearly not be a position which we would support. … 2. That there is no diminution of service to us as an employer. [Lothian Pension Fund] staff have always been very responsive to any questions from us and have met us on a number of occasions to discuss particular items face to face. If we cannot be guaranteed of the same level of service from a merged body, we would not be supportive of any such change. *Edinburgh Leisure*

Considerations for implementing change:

The effort and potential disruption should not be underestimated. Do funds have the capacity to cope with managing the change? *SEPA*

It is recognised that if merger is pursued, a significant body of work would require to be undertaken by the Scottish Government, SPPA and the Funds. This could however be scheduled over a sensible time period taking account of day to day demands on "trustees" and officers. Fundamental would be "getting the governance right" in order to have an end product that married technical knowledge with clarity of decision making, accountability and broad stakeholder representation. *Falkirk Council Pension Fund*

There are also political drivers as well as the need to ensure that the right level of resource is available to the new consolidated scheme…None of these challenges, however, in our view, are insurmountable and really just need commitment to achieve the objective and a clear plan to do so over a reasonable timescale. *Robertson Group*

Like all proposed new ways of doing things, care must be taken not to expect a change to immediately address all current concerns; and merger will require an initial cost outlay and upheaval of the status quo. That will be against the interests of stakeholders both within the SLGPS structure and those private sector companies that gain from fees charged to multiple Scottish funds for advice and investment management. *Scottish Water*

It is worth noting the practical consideration of any proposal to create a merged body which would include an in-house investment team: Given that LPF is the only fund in Scotland with an in-house investment team, a scaling up of the LPF team to incorporate the greater funds under management is probably the most pragmatic route to achieving the aforementioned benefits in the short/medium term. If this option was deemed not to be politically expedient, another possible response may be to encourage mergers on a voluntary basis, with the caveat that the SLGPS Advisory Board mandates immediate full cost transparency and maintains oversight for the next five years, with a view to collating and comparing all fund performances over that period. The Advisory Board could flag up now their intention to conduct a further review in 5 years with the potential outcome being a mandated merger to a best in class model if the individual funds cannot evidence that they have taken steps themselves to reduce total costs as a proportion of fund values whilst delivering investment growth which compares favourably to a stated benchmark. *Edinburgh Leisure*

We believe that any consideration to a staged approach to implementation based on an initial merge to more than one fund, would require a directive rather than voluntary approach for the existing funds to work together to deliver an effective model in order to make such 'Merged Funds' into a viable reality. This approach should ensure an effective governance structure is established, a consistent approach to the transparency of costs and utilisation of in house investment management, to drive sustainability of employer contributions in the longer term. An appropriate governance mechanism should be put into place to oversee this transition. *Police Scotland*

UNISON Scotland supports the development of a single merged fund for Scotland (Option 4). We accept that this cannot be achieved overnight and much more work needs to be done to turn this option into a practical proposal. In the interim period we believe that funds should be required to collaborate as part of the process towards merger. This should include common systems and data collection; full adoption of the fee transparency code; a central

Environmental Social and Governance (ESG) unit; and the use of infrastructure investment pools or lead funds. *UNISON*

The impact of change on the affordability of the scheme for smaller public body employers, charity and third sector organisations should be a consideration in any business case for a changed structure. Also the timing of Brexit changes may impact on transition planning for any major scheme changes. *Children's Hearings Scotland*

3. Considerations for the structures of merged bodies

Some respondents suggested that a business case for a merger would need to include governance arrangements; required scale; statutory changes; independence of administering authorities and fairness.

Governance arrangements:

Merger would also have to be based around the best practices of current funds, including scale facilitation of in-house investment and full fee transparency where external investment management is necessary. Investment decision making would also have to be subject to effective delegation, so as to overcome the governance issues highlighted above under the options for collaboration or pooling…However, it should be noted that merger would have to overcome a number of challenges, many of which are associated with the administrative scale and need for effective governance and engagement of all stakeholders, including employers and members. Such engagement would include representatives from councils and other employers that do not currently administer the funds, disrupting the existing model where local councils take on the role of scheme managers. *Scottish Water*

This would rely on a revised governance structure to be put into place, i.e. different from the existing authorities and for the funding position of different employers to be protected to prevent cross subsidies. The importance of fiduciary duty should be paramount to ensure the governance of the new merged fund operates in the best interests of its members and employers… We expect that to enable this to be successful it is paramount that the appropriate governance structure is put in place to ensure the fund can effectively exercise its' fiduciary duty for the benefit of its' members and employers and avoid the risk of any potential conflicts of interests, for example with any directive investment initiatives e.g. in local infrastructure. *Police Scotland*

Required scale:

Subject to development of a business case for change CHS would support the creation of a structure that created a smaller number of merged funds in Scotland that could deliver the benefits of scale enjoyed by Strathclyde Pension Fund. *Children's Hearings Scotland*

Evidence is also mixed that the largest funds will be the most successful in terms of funding, although this does seem to be the case in LGPS Scotland universe. *SEPA*

Statutory changes:

The merger of funds would require a change to legislation, currently funds are defined within The Local Government Pension Scheme (Scotland) Regulations 2014*. Dumfries & Galloway Council Pension Fund*

Independent administering authorities:

It may be preferable for a merged fund to be managed independently of local authorities so as to avoid conflicts of interest for fund officers and elected officials. Governance of such a fund would need to be carefully constructed so that it did not become inappropriately exposed to pressures from political or other interest groups, which would hamper the fund manager in carrying out their fiduciary duty to fund members and employers. *Scottish Water*

Fairness including measures to cover cross-subsidies of deficits; safe-guarding local economies; and standardisation of benefits:

> Members were concerned about the risks associated with merger that the surplus built up by the Fund could be converted to a deficit if merged with under-financed schemes. Therefore Highland Council would want a guarantee from the Scottish Government that if funds do end up being merged any deficit not made up by the employer will be funded by the Scottish Government. *Highland Group*
>
> If increased contribution costs could not be absorbed by employers facing increases, this could lead to job losses in these areas. Dundee could be more significantly impacted by this as unemployment in the area tends to be higher than in other parts of Scotland, and as part of the Tayside Pension Fund only paying 17%, an increase of 2 or 3 percentage points could be problematic. As stated earlier there could be a mechanism for redistributing funding from "winners" to compensate those who lose out. CI/SSSC would be concerned about how this could be extended to admitted bodies. *CI-SSSC*
>
> Any form of merger that included the Shetland Island Council Pension Fund would need to be Island Proofed. This brings in an islands awareness into the decision to ensure that any impact of the change does not harm the interests of the Shetland Community. *Shetland Islands Council*
>
> There should be no merger of liabilities - contributing employers would retain responsibility for their own as at present. *UNISON*
>
> The LGPS funds all provide consistent benefits based upon a single regulatory framework. Consolidation would remove regional variations and inconsistency. Legacy arrangements would have to be clearly documented and honoured but future practice could be implemented on a wholly fair and consistent basis. *Robertson Group*

4. SLGPS should merge into two or three funds

Responses said merger into two or three would allow scale benefits to be gained while retaining more local governance:

> SEPA is of the opinion that it would make sense to create 2 or 3 independent Pension Management Bodies for Scotland. The reasons for suggesting 2 or 3 are: Strathclyde is sufficiently large to reap benefits of scale, merging into one fund is unlikely to benefit them; one fund would be susceptible to government pressure, particularly in times of economic stress…These single purpose Pensions Bodies should be responsible for the day to day operation of the scheme. Such single purpose bodies should lead to improved staff skills and competencies and encourage development of in-house investment management teams.
>
> How each Body is structured will depend on their geographical coverage and how they think they can get the best value for money. Their structural design should support their needs in the most appropriate manner, this maybe by having a central office with local support. Or it may be consolidating all activities into one office.
>
> Each Body should have a Board that consists of Employer 4 reps (from councils (councillors or chief Finance Officers) or other membership bodies), 4 Employee reps, 2 pensioner reps and 2 independent members. The independent members will provide challenge and ensure the Board is managing the fund within existing legislation/ regulation.
>
> To maintain the level of knowledge required to be effective in these roles it is suggested that they become 10 year terms of office.
>
> These Pensions Bodies Boards must have an active local engagement programme with all its participating employers and members (pensioners, actives or deferred).

The new bodies should be given the responsibility to inform staff of their relevant employers of their pensions benefits and their options in managing their finances for retirement. *SEPA*

… 3 “SuperFunds” being created based around the existing Strathclyde, Lothian and North East Funds. A structure of this type would:

- allow the merged funds to benefit from scale investing
- deliver a strong and efficient system of governance: each SuperFund would be a single decision making entity; there would be no need for an additional layer of bureaucracy as with the pooling option
- allow centres of pensions expertise to be developed across all facets of fund activity including administration, funding and investment management for the benefit of employees, pensioners and employers alike
- enable the local government pension scheme to maintain local accountability
- assist small and medium sized funds with compliance and resilience issues

A merged structure could still include local administration hubs if a “closer to customer” service was desirable. This would have the comfort of operating under the umbrella of a merged structure. It is noted that Fund mergers have successfully taken place before (e.g. the local government re-organisation of 1975 when County Council funds were merged with Town Council funds). The creation of South Yorkshire Pensions Authority is a further example. *Falkirk Pension Fund*

5. *SLGPS should merge into a single fund*

Some respondents presenting arguments for one merged fund as being a match to the requirements of multi-fund employers and being of sufficient scale to incorporate global best practices.

Match to multi-fund employer footprint:

From an employer perspective, the concept of interacting with a single SLGPS fund through a single set of processes is attractive…It should be possible for a merged single fund for the SLGPS to retain local service delivery. For example, the fund could maintain local offices in some or all of the local authorities that currently act as administering bodies, as would be necessary to engage with pensioners and deferred members who do not have a current employer through which they can interact with the fund. Smaller employers may also benefit from having a local source for advice on administration (which would in any case be greatly simplified by interaction with a single scheme).*Scottish Water*

The SFRS would prefer a single Administrator as this would simplify our administrative processes and our costs (8 to 1). *Scottish Fire*

As mentioned above as a multi fund employer to ensure sustainability over the longer term, we would prefer for all our employees to be within one LGPS fund. However there are challenges in the differences in funding and governance amongst the existing funds with differing funding levels amongst the existing funds and realisation of any cessation shortfall among the financial barriers to consolidation. These challenges although not insurmountable would be removed if the current LGPS funds were merged into one fund. *Police Scotland*

A fund large enough to incorporate global best practices:

Our vision for a new one fund for Scotland includes:

- A single clean governance model, probably based on a Joint Board model to retain local authority, trade union and other employer engagement, as well as retaining VAT exemptions. A single employer lead would have governance problems and an NPDB would be open to political interference from government. The statutory Pensions Board could either be incorporated into the governance model or operate in tandem, as with the current Scottish system.

- Common data collection and systems to improve the transparency of performance and address inconsistencies in the current system.

- An in-house investment team that delivers the benefits identified in the SAB research reports - drawing on the experience of funds like Lothian, West Yorkshire and RailPen. This approach is both cost effective and can facilitate appropriate infrastructure investment on a much greater scale.

- Control of investment costs through fee transparency and in-house teams.

- An ESG unit that ensures ESG assessments are undertaken on all investments, and delivers active shareholder engagement. It would develop best practice in relation to ethical investment in accordance with the values of our members and the public services they deliver.

- A one Scotland fund would be a significant national and international investor, able to adopt the best practice we have seen in public service pension schemes across the world. It will be a challenge to deliver, but the opportunities are significant *UNISON*

Arguments against Option 4: Merger

Respondents presented the following additional arguments against Option 4, merger: [27]

1. Evidence on benefits of scale and execution risks

2. Admitted bodies, non-LGPS funds and deficits

1. Evidence on benefits of scale and execution risks

Respondents provided additional detail to some arguments dealt with earlier with earlier including: lack of evidence and execution risks.

Lack of evidence or certainty of benefits of scale:

> Whilst a fund of this size would undoubtedly enjoy benefits of scale, size is not a guarantor, nor necessarily a determinant of success. The UK's 2 largest pension funds are the Universities Superannuation Scheme (USS) and the British Telecom Pension Scheme (BTPS). Both have assets of around £50 billion (a little more than the combined value of the Scottish LGPS funds). Both are very well managed in many respects. Yet both have significant funding deficits – in excess of £10 billion in each case – and are contemplating, or have effected closure of their schemes to new defined benefit accrual. *SPF*

Execution risks and uncertainties:

[27] Respondents summarised some arguments made earlier including: loss of local connection; concentration risks; potential changes in contribution rates; merger restructuring costs; recouping of merger costs leading to investment in assets with higher risk profiles; lack of benefits demonstrated by pooling in England and Wales; lack of scale benefits; job losses; untested model and uncertainties; and risk of political interference.

> Administration would suffer as evidenced by transfer to SPPA of police/fire. *SPDS*

> Work published by Audit Scotland has repeatedly questioned the effectiveness of merger processes in the public sector. *Glasgow Kelvin College*

> Day to day administration is already extremely complex, with multiple sets of regulations to apply, and merging the Funds opens up likelihood of risk of errors/omissions e.g. incorrect payments and reputational risk. Although there is the likelihood of a more consistent administration service for members and employers, this does not ultimately mean they will receive a better service. There are far simpler ways to achieve this through collaboration and co-operation across the 11 Funds to develop a more consistent approach. *NESPF*

2. Admitted bodies, non-LGPS funds and deficits

Respondents said that the mergers could affect admitted bodies and the ability of councils to manage other non-LGPS funds.

Impact on admitted bodies:

> A merger of certain funds or a full merger of all the funds could have consequences for a Pension Fund's admitted bodies, and future bodies wishing to join the Pension Scheme. A current admitted body will be further removed from the governance of the Fund, and would not have any representation as they currently do at present on the Pension Board. Any change to a current admitted body's status could affect their continued inclusion in a merged Fund. Also, future bodies wishing to join may not be able to join on similar terms as current admitted bodies, and may find barriers to joining through excessive covenants or minimum size requirements. This may be a more acute issue due to the smaller size of island based organisations. *Shetland Islands Council Pension Fund*

Ability to manage other, non-LGPS funds:

> The Orkney Islands Council, the administering authority for the Orkney Islands Council Pension Fund, also manages a portfolio of £215m of managed funds investments associated with the operation of an Oil Port under the Orkney County Council Act 1974. It is considered that the resilience of both Council members and officers to discharge their duties effectively would be adversely impacted if the Pension funds were to be merged into one or more funds. This could potentially see both the governance and performance of these non-pension fund investments deteriorate going forward, which would not be in the best interests of the people of Orkney. *Orkney Islands Council Pension Fund*

6. Additional comments

Respondents provided additional comments on the criteria that could be used to evaluate options on the structure of the SLGPS and considerations for socially responsible investing**.**

What criteria should govern choice of future structure?

Respondents proposed criteria to evaluate the effectiveness of SLGPS pension funds and consultation options:

Audit Scotland:

> In our role as an employer, we consider the following aspects of the SLGPS as key elements of pension fund operation - irrespective of the future structure of the scheme(s):
>
> 1. Funding
>
> The funding of pensions across the SLGPS needs to be affordable, sustainable and fair for employers and employees. The funding strategy, coupled with the investment strategy, needs to ensure that risk is managed so that the SLGPS is resilient.
>
> 2. Investment
>
> The principle of value for money applies to all aspects of SLGPS operation, including the considerable cost of investment management and administration. The cost of investment management needs to be balanced with the potential for investment fund returns which, when taken together, provide evidence of value for money. The investment element is a significant factor in both cost and investment returns, with a corresponding impact upon future funding strategy.
>
> 3. Governance
>
> Effective governance includes the principle of clear accountability between the SLGPS fund(s), employers and members. Accountability was strengthened as part of the SLGPS 2015 scheme. The capacity and capability of key personnel and specialists within each SLGPS fund ensures operational and professional resilience – including the ability to effectively procure, monitor and manage external suppliers such as investment management firms.
>
> Governance also includes the important matter of fiduciary responsibilities to scheme members, including important safeguards in this area extending to investment asset class choices, risk management strategy, transparency and trust.
>
> 4. Administration
>
> Employers and members rightly expect a consistent, effective and efficient level of service from pension fund administrators which are accessible for all stakeholders. SLGPS administrators should seek to deliver this however they choose to organise themselves. *Audit Scotland*

COSLA:

> COSLA believes that the position agreed by COSLA Leaders in 2014 at the time of the setup of the amended pension management arrangements, remains just as relevant at this time. COSLA Leaders agreed the following key principles which must underlie any review of the structure of the local government pension scheme:

1. Any decisions on the number and structure of the Funds are to be made in line with long term stability and sustainability of the Funds and not for short term political reasons.

2. Any review must take adequate cognisance of risk and cost/benefits of any change.

3. Any review must be based on solid and reliable empirical evidence and not supposition.

COSLA firmly believes that the SAB should take full and proper consideration of these key principles when considering and advice on further work in relation to structure review of the local government pension scheme. *COSLA*

Considerations for socially responsible investing

Unite gave evidence on the role of socially responsible investing as a consideration for the structure of the SLGPS:

With the impetus nationally and globally on sustainable development goals, responsible investment must now take account of investment such as those that lead to carbon reduction; that avoid investment in the arms industry and protects wildlife. Unite believes it is important that pension fund investments take account of wider concerns about such issues. Changes to the scheme must ensure more socially responsible decisions in pension fund investment.

However, while a responsible investment philosophy may be admirable and is certainly a desire, the fund is required to make money. Therefore Unite recognise that while the move to socially responsible investment may not be done over-night it should certainly be a route that influences decisions going forward.

Unite is aware that some decisions to invest in less socially responsible projects are made by fund managers for specific financial reasons. Going forward such decision should be scrutinised by trade union representatives in order to provide the opportunity to influence the decision before a final resolution to invest is made. There must be strict risk-based parameters put in place on investment decisions. All decisions should be made on a unanimous basis. It is not acceptable for a fund manager to have a controlling influence.

Only recently it was uncovered that a number of Scottish based pension funds had investments in companies linked to the detention of immigrants at US border camps. Unite was asked by the media to comment. The uncovering of this type of unsavoury investment and the media interest it attracted was unwelcome. Unite nevertheless believes it is possible to invest in a way that takes account of corporate social responsibility, and remains profitable.

The consultation paper places significant importance on the potential for investment in infrastructure. While Unite would have no specific issue with the pension fund investing in communities and other infrastructure projects locally, we would require guarantees be put in place in terms of wider construction projects to ensure the projects abide by the Unite Construction Charter, i.e. ensure direct employment, no bogus self-employment or umbrella companies, payment of the living wage etc where SGLPS has been used to fund it. *Unite*

Appendix 1: List of respondents and preferred option

Name	Type	Preferred Option[28]
Abdereen City Council	Local Authority	2
Aberdeen City Council Pension Fund	Pension Fund	2
Abertay Housing Association	Employer	2
Abertay University	Employer	2
Argyll and Bute Council	Local Authority	2
Audit Scotland	Employer	
Care Inspectorate	Employer	2
Children's Hearings Scotland	Employer	4
CIPFA Scottish Local Authority Directors of Finance Section	Professional Services Body	
Comhairle nan Eilean Siar	Employer	2
COSLA	Employer Representative	2
Dumfries & Galloway Council Pension Board	Pension Board	2
Dumfries & Galloway Council Pension Fund	Pension Fund	2
Dundee City Council	Local Authority	2
East Ayrshire Council	Local Authority	1
East Lothian Council	Local Authority	2
Edinburgh Leisure	Employer	4
Falkirk Community Trust	Employer	4
Falkirk Council Pension Fund	Pension Fund	4
Fife Pension Fund	Pension Fund	2
Fife Council	Local Authority	2
Glasgow City Council	Local Authority	1
Glasgow Kelvin College	Employer	1
Highland Council	Local Authority	1
Highland Council Pension Fund	Pension Fund	1
John Anzani, member, Pensions Committee of City of Edinburgh	Pensions Committee	
Live Borders	Employer	1
Lothian Pension Fund	Pension Fund	4
Lothian Pensions Board	Pension Board	4
North Ayrshire Council	Local Authority	1
Orkney Islands Council Pension Fund	Pension Fund	1
Pensions Committee of City of Edinburgh	Pensions Committee	4
Perth & Kinross Society for the Blind	Employer	2
Police Scotland	Employer	4
Renfrewshire Council	Local Authority	2
Robertson Trust	Charity Employer Representative	4
Royal Conservatoire of Scotland	Employer	1
Scottish Borders Council	Local Authority	2

[28] In a minority of responses there was some uncertainty whether Option 1 or Option 2 was preferred. We have made our best judgement in these instances.

Scottish Borders Council Pension Board	Pension Board	2
Scottish Borders Council Pension Fund	Pension Fund	1
Scottish Children's Reporter Administration	Employer	4
Scottish Fire and Rescue Service	Employer	4
Scottish Police Authority	Employer	4
Scottish Social Services Council	Employer	2
Scottish Water	Employer	4
SCVO	Charity Employer Representative	4
SEPA	Employer	4
Shetland Islands Council	Local Authority	1
Shetland Islands Council Pension Fund	Pension Fund	1
Society of Personnel and Development Scotland	Professional Services Body	2
South Ayrshire Council	Local Authority	2
Strathclyde Pension Fund	Pension Fund	1
Tayside Pension Fund	Pension Fund	2
UNISON	Employee Representative	4
Unite	Employee Representative	3
West Dunbartonshire Council	Local Authority	2

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