

Review of the Structure of the Scottish Local Government Pension Scheme

CONSULTATION RESPONSE FORM

Instructions

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

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

RESPONDENT DETAILS

Name of responding organisation(s) Please list the full name of each organisation participating in this response.	Organisation type Is your organisation an administering authority, employer, or employee group? Please record for each responding organisation.
Scottish Borders Council Pension Board	Pension Board
Authors Please list any people that wish to be recorded as authors of this response, including name, job title and organisation.	Consent Please confirm each author consents to their information being retained for analysing the consultation responses by writing 'confirm' by their name.
	confirm
Date Please date the response.	30/11/18

Covering information

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

The Scottish Borders Council Pension Board was established under the Local Government Pension Scheme (Governance) (Scotland) Regulations 2015.

Joint meetings of the Pension Fund Committee and Pension Board have been held regularly following implementation of these regulations on 1 April 2015.

The remit of the Pension Board is to assist the Council (as administering authority) in relation to:

- a) securing compliance with the regulations and other legislation relating to the governance and administration of the Scheme and any statutory pension scheme that is connected with it;
- b) securing compliance with requirements imposed in relation to the Scheme and any connected scheme by the Pensions Regulator; and
- c) such other matters as the regulations may specify.

The Board is made up of four scheme employer representatives and four trade union representatives.

The Pension Fund places assurance on the activities of the Board is fully compliant with the relevant legislation.

The arrangements associated with the Board are still relatively new having only been in place since 2015. They have however significantly enhanced the governance and scrutiny of the Fund's activities and also provide a strong voice for local employer and employee representatives.

The management of the Scottish Borders Pension Fund is assisted greatly by the involvement of local elected members, local trade unions representative and local employers in the decision making process through both the Pension Fund Committee and the Board.

The Board believes that effective governance and oversight of the pension fund can best be achieved at this local level where employers and employees can actively participate in, and influence decisions through well-established local governance arrangements. These arrangements need to be given time to bed in before any further changes are considered to the governance or management structure of the LGPS in Scotland.

The Board believes there is no compelling evidence to support the case for change and that unnecessary structural change could have a significantly detrimental effect on member confidence, investment performance and funding levels.

The evidence published and quoted by other respondents in support of change is at best selective. Pension fund reforms being undertaken in England and Wales have proved expensive to date and have yet to demonstrate any material benefits.

Having considered the published data and the draft responses of other respondents the Scottish Borders Council Pension Board has concluded that there is no reliable empirical

case for reform 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 pension fund membership.

The Board accepts that more effective collaboration between funds has the potential to deliver some cost benefits, as well as realising potential advantages in other areas for example the procurement and upgrade of systems and the sharing of best practice and for these reasons supports a voluntary collaboration model, based on option 2 in the consultation . This would avoid the need for pooling or expensive, time-consuming structural reform to deliver theoretical, but as yet unproven, benefits and un-evidenced cost savings.

The consultation questions follow.

CONSULTATION QUESTIONS

Question 1: Retain the current structure with 11 funds

The text can wrap onto additional pages.

a) Cost of investing:

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

The Board is fully informed through joint meetings of the Pension Board and Pension Fund Committee of the costs of administering the fund.

How well does the current system manage investment costs?

The Board has access to good information with regard to fee levels charged by fund managers. 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.

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

All fund managers employed by the LGPS should be required to disclose their full fee structure in line with the fee transparency code.

Governance:

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

The Pension Board with strong local employee membership has added a positive new dimension to the governance of the pension fund. The Board primarily relies on the opinion of Audit Scotland, the views of the actuary and the support of officers to gauge how well the fund is meeting the standards of good governance.

The Fund's annual Governance Statement under the 2014 regulations demonstrates compliance with the governance standards required by Scottish Ministers.

- ***How well is the current system governed?***

The 2016 KPMG review of the governance of the LGPS concluded positively with regards to the standard of governance in place across the LGPS in Scotland.

Pension Fund Boards have added a further positive dimension by ensuring scrutiny of pension fund committee decisions and effective employee representation in the management of pension funds.

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.

- ***How would you improve governance of the current system?***

Pension Fund committees should continue to meet jointly with Pension Boards on a regular basis and committee meetings should be held in public wherever possible.

The minutes of meetings should be published.

The introduction of Boards and the Scheme Advisory Board has added an extra layer of governance and oversight and 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.

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

The LGPS is a local service. The Scottish Borders Council Pension Board believes that decisions that affect local people are best made locally and that these decisions should be as transparent and open as possible.

The Board believes it is important therefore 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 dependents and those charged with taking decisions. Such close alignment improves accountability and transparency.

Decisions with regard to investments, environmental social and governance issues, risk management etc. should kept as local as possible so that those charged with ensuring effective governance can be held accountable to their members and the local electorate for their decisions with regard to oversight, strategy, and ultimately, their stewardship of the pension fund. In the Borders the local nature of decision making guarantees an effective voice for employee representatives on pension fund boards.

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

There is no evidence that larger sized pension funds perform better, or that they have fundamentally lower costs. There is no relationship between scale and the effectiveness of governance either at a local or at a more aggregate level.

Operating risks:

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

The pension fund committee and the pension board in the Borders holds regular joint meetings with their advisors, fund managers and officers to ensure the risks associated with their investments are fully understood. The Fund has robust risk management arrangements in place which are subject to regular quarterly review.

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

The performance of the LGPS in Scotland and the content of external audit reports

indicate these risks are being managed effectively. The Board is supported in its governance role by high quality managers, professional officers, an independent expert advisor KPMG, external Custodian Northern Trust and the fund Actuary Barnett Waddingham.

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

By requiring members to undertake mandatory training e.g. the Trustee toolkit to ensure they have a good understanding of operating risks.

By requiring each fund to publish a comprehensive risk register for the fund which is subject to regular review.

Infrastructure:

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

The Board is fully informed through regular reports and information updates of all the Fund's investments including infrastructure

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

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. Funds can and do already invest in infrastructure as part of a balanced approach to investment.

Scottish Borders has made an allocation of 5% of its assets under management to infrastructure and is investing in this asset class in collaboration with Lothian Pension fund.

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

The attractiveness of this asset class can only be assessed in comparison to the risk and return profile of infrastructure vis a vis other investment opportunities.

Having an appropriate vehicle to access infrastructure investment in a cost effective manner would greatly assist this process. The structures to easily enable such large scale investment in infrastructure, which balances suitable returns within an optimized risk profile, with low cost project funding which can match PWLB costs, are not however yet suitably developed. Development of such a model would help to facilitate infrastructure investment.

Do you have any additional comments about this option?

This option is based upon the continuation of the current structure of the LGPS in Scotland. It is by any standards a significant success story with over £44b of assets under management at 31 March 2018.

The LGPS in Scotland is in a fundamentally different place to funds in England and Wales both in terms of funding levels and investment performance. Any changes made to the current system, which is performing well, and appears to be governed effectively

assisted by the operation of the new Pensions Boards, run the risk of being an expensive distraction in the short to medium term.

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.

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

The text can wrap onto additional pages.

a) Cost of investing:

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

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. Funds collaborating in investment opportunities could realise benefits in terms of fees through larger co-investments.

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

Economies of scale may be delivered to some of the smaller funds. Larger funds are unlikely to benefit materially. Overall cost gains are likely to be marginal for the LGPS in Scotland.

Collaboration and cooperation will give all funds the benefits of sharing experience and best practice.

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

Collaboration does not remove the requirement for individual funds to undertake due diligence regarding prospective investments. If funds do agree to collaborate they will still be required to undertake their own robust diligence exercise before committing to invest.

Governance:

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

Collaboration may encourage the sharing of good practice although this is already widely shared nationally at officer level.

Collaboration would not remove the requirement for each fund to ensure its governance arrangements are operating effectively, that proper advice is followed at all times and that appropriate due diligence is undertaken before investing.

• **What would be the positive impacts?**

Sharing of best practice and closer cooperation on co investment opportunities should have a positive impact.

• **What would be the negative impacts?**

Collaboration would not remove any of the existing governance and audit requirements.

Operating risks:

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

There would be little if any material impact on operating risks through this option.

What would be the positive impacts?

There could be potential benefits through economies of scale and collaboration on the joint development and testing of systems.

What would be the negative impacts?

There could be an increased cost arising from legal agreements to underpin collaboration.

d) Infrastructure:

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

In practice this arrangement is already working effectively with respect to infrastructure.

• **What would be the positive impacts?**

Smaller funds could 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.

Closer collaboration would allow the retention of local expertise in the Finance and HR function providing depth and resilience across Scotland, particularly in smaller authorities, which would otherwise be lost.

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

There would be a need for additional legal documentation to avoid the potential for disagreement and challenge arising from service failure or adverse investment returns.

Do you have any additional comments about this option?

Collaboration would mitigate key person risk in smaller councils which would arise as a direct result of other options.

Question 3: Pool investments between the 11 funds

The text can wrap onto additional pages.

a) Cost of investing:

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

Pooling of investments would require significant restructuring of LGPS investment mandates at significant cost.

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

There could be a positive impact on some of the smaller funds' fee costs from investment pooling. The larger funds e.g. Strathclyde are unlikely to see much if any benefit due to their existing scale.

Reducing costs is important but will only deliver benefit if it improves net investment returns.

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

There is no evidence as yet of any benefits that pooling may provide. Investment management fee reductions may be delivered but these are also likely to be offset by transition and reorganization costs.

This would require an additional level of expensive governance at pool level which could be avoided.

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

Pooling should only be undertaken if it provides significant advantages to the Fund.

These advantages will differ depending on the circumstances of each fund.

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

Using direction to force pooling is strongly opposed by the Scottish Borders Pension Board. The only circumstances where this should be considered is if there was sustained evidence of governance failures at a local level or evidence that funds were completely unable to meet their long term liabilities on an actuarial 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.

b) Governance:

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

Pooling is likely to require additional governance and administrative structures to be established.

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

There is as yet no evidence that pooling has had a positive impact in England and Wales.

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

This option may require additional layers of governance, lessen local involvement in investment decisions, lessen the voice of local employee representatives and make decision making more remote.

c) Operating risks:

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

There is likely to be little impact on operating risks arising from pooling. Day to day investment would continue to be carried out by investment managers.

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

SBCPF Board could not identify any positive impact on operating risks from pooling.

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

The major impact will be the need for an additional expensive fund governance structure operating at pool level.

d) Infrastructure:

- ***What impact do you think pooling investments between funds would have on***

funds' ability to invest in infrastructure?

There will be little impact on the ability to invest in infrastructure. Decisions to invest in infrastructure are based upon an 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.

- What would be the positive impacts?***

None

- What would be the negative impacts?***

None

Do you have any additional comments about this option?

Yes.

There are significant risks associated with this option and a lack of empirical data in its support.

Pooling will introduce an added layer of bureaucracy. Staff would be required to run the new pools at potentially significant cost if staffing arrangements and grades sit out with current local government pay structures.

There is no evidence yet that the new pooling arrangements in England and Wales have delivered any cost benefits, improvements in governance, or that they have fostered a greater desire to invest in infrastructure.

The costs associated with pooling may be significant. It will be time consuming and be a distraction from the primary purpose of pension funds i.e. to build a fund of assets to meet liabilities. It will require substantial additional costly professional advice from pension fund managers, investment consultants, actuaries and lawyers.

The LGPS in Scotland would be well advised to await the publication and evaluation of the benefits and issues that have arisen with pooling elsewhere before pursuing this option.

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

The text can wrap onto additional pages.

a) Cost of investing:

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

Merger would require significant restructuring of LGPS investment mandates at significant cost. The study undertaken by Mercers does not support the view that larger fund always have lower costs or that they perform better based on their snapshot analysis of the LGPS 2015 accounts.

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

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 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.

What would be the negative impacts?

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. The larger funds that already enjoy these benefits of scale are unlikely to see any benefits in terms of cost reduction as they already access the cheapest fees levels.

The proposal is untried and the risks of merger are not fully understood.

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

Forced merger could it is thought require primary legislation.

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

As per the answer to option 3 above this should only be considered where there is significant evidence of governance failures at local level or there is a clear inability to meet future liabilities following a deficit recovery period agreed with the fund actuary.

b) Governance:

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

It would have a significant adverse impact on local governance for those councils who currently operate a fund.

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

There may be some economies of scale.

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

This would effectively remove a local service from local control. Recent examples of merger in other services at national level have proved to be controversial and problematic with concerns over governance and a lack of clarity regarding the realisation of the original objectives.

c) Operating risks:

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

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.

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

This option would reduce key person risk for smaller pension funds.

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

This option would increase pressure on remaining council staff and as TUPE would be required it would reduce senior capacity at local level.

d) Infrastructure:

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

It is unclear how merger would assist with the process of investment in infrastructure. If such investment is identified as being the correct course of action for funds as part of their asset allocation strategy this should be pursued. A number of pension funds are already investing in infrastructure however the process is hindered by lack of suitable investment vehicles. Collaboration without restructure provides an equally valid route to access infrastructure at potentially much lower cost.

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

A larger fund may have more appetite for alternative infrastructure investments as part of their asset allocation strategy.

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

There is a danger that merger is seen as providing a solution to a political aspiration. Potential Investment in infrastructure should not be seen as a driver for the merger option.

See below

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

New governance arrangements would be required and this would incur additional costs

during transition.

The move to formal restructure would lessen links to local decision making for example with regard to investment strategy and asset allocation, removing a key role for elected members in the governance of pension funds.

The effect on employer contributions 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 including SBCPF also have some of the highest longevity for fund members which has a bearing on their funding level.

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.

Full Merger is likely to require expensive restructuring. There is no evidence that this would deliver tangible benefits when compared to current arrangements.

Any move to restructure the current LGPS must be based on sound empirical evidence that it will deliver tangible improvement for both large and smaller funds when compared to the current structure.

The process of merger may unsettle the membership of the LGPS encouraging transfers out of the fund and discouraging new entrants.

Question 5: Preferred and additional options

The text can wrap onto additional pages.

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

The Scottish Borders Council Pension 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.

An ill thought through change based on limited data risks undermining the success story that is the LGPS in Scotland.

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

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

There are no other options SBCPF Board could identify that would improve on the current position.

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

N/A

- c) **Are there any other comments you would like to make?**

No

The consultation questions end.