

Overview of Lothian Pension Fund's (LPF's) Interim Response to the Scottish LGPS Scheme Advisory Board's Consultation on Structure

Introduction

The Scottish Local Government Pension Scheme (SLGPS) is a single national scheme providing retirement benefits that are enshrined in statute. As a result, the structure should not affect member benefits directly. Changes to the structure could, however, affect employers directly – their contributions are impacted by investment returns and funding, which depend on costs and efficiency. Whilst the current overall funding positions of the SLGPS funds are certainly healthy, there should be no room for complacency and opportunity to address inherent structural inefficiency should be grasped. The long-term sustainability of the Scheme should be the primary driver for any change.

LPF believes that governance is critical to any potential structure and should be the primary consideration.

- Governance needs to revolve around fiduciary duty of the SLGPS to its members and employers. This applies to investments, including those in infrastructure, which need to be made in the best interests of employers and members. LPF has a significant allocation of 12% in infrastructure.
- Accountability is critical in the structure, including to representatives of local taxpayers (who ultimately guarantee the SLGPS benefits) and members of the Fund, to ensure the Scheme is managed in their interests
- The governance needs to ensure that it has personnel able to dedicate sufficient resources, and with the requisite levels of expertise/experience, to effectively administer the fund
- There are many vested interests including those involved in its governance, officers, advisers, investment managers and other providers, many of whom could be adversely affected if the SLGPS structure changed.

LPF is cognisant that its governance arrangements are quite different to (most) other SLGPS funds. Therefore, in its response to the consultation LPF has considered what is in LPF's interests as well as the SLGPS as a whole.

Option 1 – Status Quo

LPF has developed its governance to reflect best practice within the constraints of the current regulatory structure, including:

- Representation of employers and members on the Pensions Committee
- Employment of an Independent Professional Observer to provide support to Committee and Board
- Delegation of investment strategy implementation to the Head of Finance taking advice from a professional Investment Strategy Panel of internal and external independent advisers
- Delegated "Section 95" finance officer responsibility to reinforce the statutory ringfencing of LPF from the Council
- Internal investment team, with appropriate risk controls and oversight, which brings greater alignment of interest and reduced costs. This has enabled significant investment in infrastructure.
- Separate employment of LPF resource to bring enhanced controls and, critically, the ability to recruit and retain resource.

However,

- Information on the performance of the overall SLGPS is lacking. Comparable data from individual funds is also deficient, particularly in relation to investment costs. This lack of clarity has hindered previous reviews of the SLGPS structure and remains a very relevant factor today. LPF has been a proponent of investment cost transparency for a number of years. Whilst each fund is subject to scrutiny through its own governance and audit, the lack of consistency of information makes it difficult for stakeholders to judge the effectiveness of the Scheme as a whole.
- LPF believes that the current structure is inefficient. It is widely acknowledged that investment is a scale business and, in general terms, larger funds can achieve lower fees. Increased size also brings greater investment opportunities. The combined SLGPS is smaller than some of the largest UK pension funds, including Universities Superannuation Scheme and BT Pension Scheme. With the potential exception of Strathclyde Pension Fund (£21 billion), all other SLGPS funds, including LPF, would benefit from greater scale.
- Governance of the SLGPS is also inefficient. In the region of 150-180 people are involved in the Pensions Committee and Pension Boards, many with limited knowledge and experience of pension matters
- Employer contributions required to meet the costs of the Scheme have risen significantly in recent years
- Councils acting as Administering Authority bring governance issues including limited involvement of stakeholders and conflicts of interest for both officer and elected members
- There are significant key person risks and funds generally lack internal resource. As a result, funds are heavily and unduly reliant on external suppliers
- There is significant duplication of effort across the Scheme. Employers who participate in more than one fund experience inconsistencies in funding, data, administration etc., leading to inefficiencies.

Option 2 - Greater Collaboration

In recent years, LPF has made significant inroads in its collaboration via its FCA authorised company through which it advises other funds and hence allow funds to work together, address key person risks and develop trust within the current structure. These developments in collaboration, with like-minded investors, are welcome. Partner funds are benefiting from LPF's internal resource and LPF is sharing its costs. However, there has not yet been any significant impact on any of LPF's investments. The arrangements are expected to evolve and for LPF to benefit from greater overlap in investments. The success of the arrangements will need to be assessed in due course.

The governance of LPF's collaborative arrangements is not straightforward. While other funds rely on advice from LPF, they need to continue to be resourced appropriately to make decisions for their respective funds. Further, there are practical constraints to the expansion of this type of collaboration.

LGPS (UK) National Frameworks (lead by the Norfolk Pension Fund) are in place and have proved beneficial to date. However, there is evidence that the pooling of investments in England and Wales will impact on the services available through this route.

LPF would have concerns over the governance of greater collaboration. Those involved would need to be suitably aligned, resourced and avoid conflicts.

Overall, LPF has concerns that relying solely on greater collaboration could be sub-optimal, could potentially adversely impact on LPF and avoid more integrated change which is necessary to achieve optimal efficiencies.

Option 3 - Pooling

Whilst pooling might be expected to reduce investment costs, governance is not straightforward e.g. clarity of decision making between funds and pool. Further, an extra layer of governance (and hence cost) is likely to be introduced into the Scheme. Therefore, pooling is not LPF's preferred option.

Option 4 - Merger

On the assumptions that merger of funds would be 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,

...merger is LPF's preferred option.

Long-term sustainable benefits, more than outweighing limited initial outlays, should 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.

LPF acknowledges that merger is not a panacea and it will involve significant change, particularly in relation to governance, which may not be palatable to some stakeholders and merger to a single fund could be difficult. Therefore, LPF's preferred option would be to work with like-minded partners on a voluntary basis to develop a mutually beneficial merger solution.

Other issues

The SLGPS Scheme Advisory Board's remit includes to *'provide advice to the Scheme managers or the Scheme's pension boards in relation to the effective and efficient administration and management of the scheme'*. LPF believes the Scheme Advisory Board should have the appropriate expertise and resource to scrutinise the performance across the SLGPS, including service and costs, including full transparency of investment costs.

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